

REPORTING FINANCIAL PERFORMANCE – A CONCEPTUAL ANALYSIS

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ABSTRACT

Reporting financial performance is among the most difficult and vexing questions faced by accounting standard-setters around the world. The group of international accounting standard setters, known as G4+1, has released two special reports on reporting financial performance over the last three years: *Reporting Financial Performance-Current Development and Future Directions* written by Todd Johnson and Andrew Lennard (Johnson and Lennard, 1998) and *Reporting Financial Performance-A Proposed Approach* written by Kathryn Cearn (Cearn, 1999). Given the current importance of G4+1 in the international accounting standards setting process, the proposals made in these two reports have important implications for future accounting practices in respect of reporting financial performance. Therefore it is important to understand and examine the conceptual basis of the proposals made in the two reports for its consistency and validity. The purpose of this research is to examine the income concepts underlying the proposals. It is conducted by a way of literature review. Several theoretical concepts of income have been identified and compared with the details of the proposals made in the reports. The four concepts of income identified are: the concept of service value income, the concept of business venture income, the concept of comprehensive income and the concept of value added income. The results of the examination show that, at the overall level, both reports have adopted an approach to reporting financial performance that is consistent with the concept of comprehensive income. At the detailed level, it seems that the concept of service value income has been adopted for developing the proposed performance statement. Based on this finding, this research discusses the inconsistencies between the underlying income concepts identified and the appropriateness of adopting the concepts. To the extent that the inconsistencies are concerned, this research paper also provides suggestions for possible resolutions.

CHAPTER 1

INTRODUCTION

Many accountants believe that financial performance reporting lies at the heart of reporting financial results. Measures of performance or business income affect many different things, ranging from share price to management compensation. As a result, financial performance reporting is one of the most controversial areas of financial reporting. The issues of how financial performance should be reported in financial statements are among the most difficult and vexing questions faced by accounting standard-setters around the world.

It is often claimed that accounting standards are to be developed in alignment with the accounting conceptual framework, therefore, development of financial performance reporting should be guided by the discussion on the theoretical concept of income. Only after the concept of income has been well defined can the reporting of income be developed systematically, as the concept of income determines which items are to be included in the financial statement, and which items are not. The importance of income concepts has also been reflected by the statement of (Philips, 1963, p.14): “progress in accounting theory must begin with income concepts”.

The group of international standard setters which includes people from the United States, United Kingdom, Australia, Canada, the International Accounting Standards Committee (IASC) and New Zealand, known as G4+1, has released two special reports about reporting financial performance.

The first special report, Johnson and Lennard (1998), is a discussion paper which addressed some of the conceptual issues associated with performance reporting. In particular, it expressed its view that measurement of bottom line figures is not adequate for financial performance reporting purposes, and that more importance should be attached to different aspects of financial results (Johnson and Lennard, 1998, para 1.3). It asserts that

a statement of changes in equity is not an adequate statement. Rather, there should be a single performance statement that will encompass all changes in equity other than those derived from transactions between the entity and the 'owners' (Johnson and Lennard, 1998, para 3.10).

Based on the single performance statement idea, Johnson and Lennard (1998) go on to propose that the single statement of financial performance should have three components: the operating component, the financing component and the component for 'other' gains and losses. Johnson and Lennard (1998) do not discuss the contents of the three components, as it was noted that at the time the report was released, the contents were still subject to further discussions.

In the second special report, Cearn's (1999) emphasises the predictive value role of financial performance reporting. It is claimed that "a key objective of financial reporting is to provide information that is useful in making predictions (and in confirming or correcting previous predictions)" about the entity's future performance (Cearn's, 1999, para 1.6). Based on this objective, Cearn's (1999) confirms the view of Johnson and Lennard (1998) that financial performance should be reported in one single statement, and further develops the three components suggested by Johnson and Lennard (1998).

In developing the three components, Cearn's (1999) did not discuss the content of the financing component claiming that the financing component will be developed later. Cearn's (1999) concentrates on the distinctions between the operating items and the 'other' gains and losses. In that, Cearn's (1999) outlines the characteristics of the operating component and based on the characteristics, she suggests the likely classification of some financial performance items such as depreciation, and gain or loss on asset disposal.

Given the current importance of G4+1 in the international accounting standards setting process, Johnson and Lennard's (1998) and Cearn's's (1999) proposals have significant implications for the standard setting and future accounting practices. They propose an idea of having just one financial performance statement that triggered debate among commentators. Some commentators, concerned about the quality of the proposal,

questioned whether the activities of G4+1 were rushed in order to get IOSCO approval (Anonymous, 1998). Others, such as Davies and Davies in the UK (1998, p. 74) state that:

The deliberations in RFP [Johnson and Lennard (1998)] have an unreal quality. Assumptions essential to its conclusions are not shared by the rest of the profession, and this fundamental disagreement casts a long shadow over standard-setting. There is a real danger that the process risks either an impasse or undermining the standard-setters' authority in a failed attempt to impose profoundly unpopular principles.

Despite the debate over these proposals on financial performance, there has been no research to examine the income concepts behind the single performance statement approach and the proposed components, or the theoretical basis of the proposals. This study seeks to provide such an assessment.

The research questions are:

What are the income concepts underlying Johnson and Lennard's (1998) and Cearn's (1999) proposals for financial performance reporting? Are the underlying income concepts consistent? Are the underlying income concepts appropriate in relation to financial performance reporting?

To answer these research questions, a comprehensive literature review on the concepts of income is first carried out. The results of the literature review show that there are four main concepts of income in the literature. They are the concept of service value income, the concept of business venture income, the concept of comprehensive income, and the concept of value added income¹. An in-depth discussion on these income concepts is provided in chapters four to seven respectively.

¹ These concepts have been referred to by different names. However the difference in names used does not materially change the ideas and views of that concept.

Because income concepts do not exist on their own, but are shaped by many related conjectures in the literature, such as theories of entity, concepts of capital and value, the discussion of income concepts requires understanding of these related ideas. Some are particularly important for the purpose of illustrating the income concepts identified in this research paper – the theories of entity. The theories of entity play an important part in the determination of income. They effectively define the relationship between the accounting entity and the equity holders and thus determine from whose perspective income should be determined. For this reason, chapter three separately discusses the theories of entity, the views of which are subsequently used to illustrate the income concepts in the later chapters.

Following the discussions on the income concepts in chapters four to seven, the features of the theoretical income concepts are compared with the proposals made by Johnson and Lennard (1998) and Cearn's (1999) in chapter eight to identify and analyse the underlying income concepts. Based on the findings in chapter eight, chapter nine concludes the research by suggesting possible resolutions for issues identified and future research directions.

CHAPTER 2

RESEARCH FOCUS, QUESTION AND METHOD

2.1 *Research Focus*

The focus of this research is on theoretical income concepts, in terms of the meaning of income, the historical background, the source of income, and the income production process, rather than the practical issues of income recognition and income measurement. The main reason for limiting the research to these few areas of income concepts is to confine it to manageable size.

The G4+1's special reports on reporting financial performance, Johnson and Lennard (1998) and Cearn's (1999) do not provide discussions for the income concepts underlying and the conceptual and theoretical implication of the proposals made. However, it is important to examine the theoretical income concepts underlying the proposals made by Johnson and Lennard (1998) and Cearn's (1999) for at least three reasons.

First, if, as the G4+1 argues, there is to be a conceptual basis for accounting development, there should be a valid conceptual basis for the proposals made by Johnson and Lennard (1998) and Cearn's (1999). To the extent that Johnson and Lennard's (1998) and Cearn's's (1999) proposals were made on a conceptual basis, the income concepts underlying the proposals need to be examined for their consistency and validity.

Second, if the proposals of Johnson and Lennard (1998) and Cearn's (1999) were made on a conceptual basis, it is important that the underlying concepts are understood because the proposals are likely to shape future accounting practices at the international level.

Third, the concepts of income underlying Johnson and Lennard's (1998) and Cearn's (1999) proposals may have significant implications on the issues of income recognition and measurement. Different countries use different income recognition and measurement rules. These different systems that are in use may not suit the concepts of income suggested by Johnson and Lennard (1998) and Cearn's (1999). Therefore, it is important for the international accounting standard harmonisation purposes, to study the nature of the income concepts underlying the proposals made by Johnson and Lennard (1998) and Cearn's (1999).

2.2 Research Question and Method

Given the apparent need to examine the theoretical implications of proposals made by Johnson and Lennard (1998) and Cearn's (1999), this research study seeks to answer the following questions.

What are the income concepts underlying Johnson and Lennard's (1998) and Cearn's (1999) proposals for financial performance reporting? Are the underlying income concepts consistent? Are the underlying income concepts appropriate in relation to financial performance reporting?

Provided with the research questions, the objective of this research is therefore to analyse the nature of income concepts underlying Johnson and Lennard's (1998) and Cearn's (1999) proposals. To be able to analyse the underlying income concepts, an understanding of the theoretical income concepts in literature is necessary. Therefore, this research is conducted by way of a literature review.

A literature review is commonly regarded as a part of research process for other research methods. However it may also be used alone as a valid research method (Burgess, 1993). Scott (1990) states that systematic documentary research, which includes literature reviews, may involve one of two interdependent focuses of interest: documents can be used as resources or as topics. When documents are used as resources, as Scott (1990) explains, the quality of the documents is appraised in terms of their value in constructing

valid descriptive statements about the things to which they refer. In this research study, the author intends to use the documents as resources to describe the conceptual background behind the proposals made by Johnson and Lennard (1998) and Cearns (1999).

A literature review is considered the most appropriate method for the research questions, because it is the only way to examine the existing development against its theoretical background. Only by examining the existing theories and backgrounds can the researcher have a deep understanding of the nature of the income concepts underlying the proposals made by Johnson and Lennard (1998) and Cearns (1999). This gives a basis on which to assess the proposals and their theoretical foundation and to give comments on their implications

Because accounting does not exist on its own but is shaped by the development in the related fields of law and economics, the literature review has not only surveyed the material from the field of accounting, but also touched on some material from the related fields of law, including tax law, and economics to determine how law and economics view income.

As the focus of this research is on income concepts, the literature review primarily concentrates on the materials on income. However, income concepts are not isolated but are inter-related to other concepts, which include capital and value concepts, and theories of entity. For example, Baxter (1975, p.20) states that “income... is a creature of value concepts.” Accordingly, the literature review also surveyed some material on them for the purposes of illustrating the income concepts.

Some of these related concepts seem particularly important – especially the theories of entity. The theories of entity discuss different views in respect of the relationship between the entity and its equity holders, and the relationship between different classes of equities. Effectively, the theories of entity determine from whose perspective income should be measured and how. Therefore this research study also briefly summarises the main theories of entity in the literature.

The above process provides a general understanding of the theoretical income concepts for examining the concepts of income underlying Johnson and Lennard's (1998) and Cearn's (1999) proposals. The income concepts identified from the literature review are used to examine the proposals by first comparing the features of the income concepts to the details of the proposals. This is to identify which theoretical income concepts underlie the proposals. After the underlying income concepts are identified, they are examined to see if there are inconsistencies and whether adopting the income concepts in financial performance reporting is appropriate.

CHAPTER 3

THEORIES OF ENTITY

3.1 *Introduction*

Theories of entity play an important part in the determination of income. Different theories of entity have different foci in terms of the relationship between the entity and the proprietors (or the stockholders), the relationship between different classes of equities in the entity. Because of these differences in focus, in effect, the entity theories determine from whose perspective income should be measured and how.

This chapter provides a brief discussion of the main theories of entity in literature. They are the entity theory, the residual equity theory, and the proprietary theory. The purpose of the discussion is to provide a background for illustrating the income concepts in the later chapters.

3.2 *Entity Theory*

The main idea of the entity theory is that the business enterprise is a separate entity existing in its own right. That is the business enterprise is treated separately from its shareholders or stockholders² as if it has civil rights and obligations of its own.

The basic accounting equation, which illustrates the entity theory, is expressed as:

Assets = Liability + Equity;

or Assets = Equity (Revsine, 1982).

² The term 'stockholder' is used here because entity theory uses terminology applicable to the corporation. Therefore 'stockholder' is more appropriate here than 'proprietors'. This should not be taken as an indication that the entity is applicable only to corporations.

The left side of the equation, assets, shows that the firm is viewed as a collection of assets, while the right side of the equation, liabilities and equity, simply explains how the assets are financed (Revsine, 1982).

The concept of separate existence and identity of the company stems from the seminal principles laid down by the House of Lords in the famous English case of *Salomon v Salomon & Co Ltd* (1897). These principles treat the company as separate from the shareholders and therefore treat the company as responsible for its own civil actions. Such actions are not the responsibility of shareholders personally.

According to the entity theory, the centre of interest is the entity itself. That means, the interests of the entity are ranked higher than those of the stockholders or the creditors (Tweedie 1979), any gains or losses should be considered from the perspective of the entity, as opposed to the stockholders.

Given the centre of interest is the entity itself, the primary objective is to keep the entity operating and to let it develop. The differences in the source of funding are of little concern. Therefore, there is no clear conceptual distinction between equity and liabilities (Hendriksen 1977, referred to by Crook, 1998). The interests of both stock holders and creditors are part of the total equities (Paton 1922; Hendriksen 1977, referred to by Crook, 1998). All classes of equities, including stockholder's equity, are considered to be the obligations or liabilities of the entity and should be treated equally. It means that any returns payable on the interests of both the creditors and the stockholders should be dealt with in the same manner. Dividends and interest on liabilities should be treated either as distribution of income (Hendriksen, 1977) or as expenses (Gynther 1967, referred to by Crook, 1998).

3.3 Proprietary Theory

In proprietary theory, there is no separation between the entity and the proprietors in the sense that the assets held by the entity are assumed to be owned by the proprietor, and the liabilities are the proprietor's obligations. The entity does not exist in its own right.

The basic accounting equation, which illustrates the proprietary theory is expressed as:

$$\text{Assets} - \text{Liabilities} = \text{Proprietorship}$$

The proprietary theory is based on the notion that “the proprietor is the centre of interest” (Hendriksen, 1977, p.488). That is, the interests of the proprietor are ranked higher than other equity holders who invested in the entity. Any gains or losses should be considered from the perspective of the proprietors with the entity viewed as an agent of the proprietors. The primary objective of the entity is to satisfy the proprietor’s wants.

The proprietary theory views the entity’s liabilities and proprietor’s equity differently. In that, while the entity’s liabilities are viewed as the proprietors obligations, the proprietors equity is not in any sense an obligation (Bird et al. 1974, referred to by Crook, 1998). An important implication of this distinction between liabilities and proprietor’s equity is that while dividends to proprietors should be considered distribution of income, interest on liabilities is considered an expense.

3.4 Residual Equity Theory

The residual equity theory can be seen as a variant of the entity theory (Hendricksen 1977, referred to by Crook, 1998). In that, both the residual equity theory and the entity theory view the business enterprise as an entity, existing in its own right, separate from the stockholders. All financial interests in the entity are obligations of the entity to the holders of the interests (Bird et.al., 1974, referred to by Crook, 1998) These views are in contrast with the proprietary theory, which does not consider the entity separately from its proprietors.

Despite the similarities between them, the residual equity theory stands as a separate theory from the entity theory, because it has views that are different from the entity theory. Unlike the entity theory, the residual equity theory does not treat all classes of financial interest equally. Rather the residual equity theory emphasises the distinction between the fixed and residual interests.

The accounting equation illustrating the residual equity theory can be expressed as:

Assets – Specific Equities = Residual Equity (Hendriksen 1977) or

Assets – Liabilities = Residual Equity (Staubus, 1959)

Liabilities or ‘specific equities’ are defined as interests that require definite fixed amounts of cash disbursements in the future, and include creditors and non-participating preferred stockholders. (Hendriksen 1977; Staubus 1959, referred to by Crook, 1998)

Under the residual equity theory, the interests of residual equity holders are ranked higher than those of the specific equities’ holders. The residual equity holders have the residual claim to the entity’s assets, that is, the residue of the assets that remain after deducting the claims to the assets of the specific equity holders (Staubus, 1959, referred to by Crook, 1998). While all returns payable on the investments of the residual equity holders are considered distributions of income, the returns payable in respect of liabilities or specific equities are expenses to be included in the income calculation.

3.5 The Enterprise Theory

Under the enterprise theory, the business enterprise is considered as ‘an *institution* in its own right’ (Suojanen, 1954). Institution, in this context has been defined as (Trustees of Dartmouth College v. Woodward, 4 Wheat., quoted by Suojanen, 1954, p. 393)

A recognised custom or form of social tradition or idea, manifested in and through human beings either in their personal conduct and relationship or through organized groups or associations

As an institution, the business enterprise is defined by its system of ideas and purposes pursued by given groups of people, such as financial interests holders and employees, which can be called ‘participant groups’. The enterprise theory endeavors to discover the role of the business enterprise in society (Suojanen, 1954).

As the enterprise is defined by its purposes, any one particular participant group has to submerge its own value judgement to the common purpose(s) of the other participants. Therefore, the business enterprise is considered as operating for the benefit of *all* groups of the participants, not any one group in particular (Suojenen, 1954). It follows that the purpose of financial statements should be to provide information on income streams to all participants of the enterprise, as opposed to just the nominal owners or shareholders. All returns payable, such as wages, interest on liabilities and dividends are considered distribution of income.

The enterprise theory is noticeably different from the theories of entity discussed previously. In that, the enterprise theory views the business enterprise as an institution that does not exist separately from society. The focus is on the relationship between the business enterprise and the society of which it is a part. In comparison, other theories of entity, including the entity theory, the proprietary theory and the residual equity theory merely look at the business enterprise as an entity in isolation in terms of its relationship with the different groups of equity holders. The entity's role in society is of less concern for these theories of entity.

3.6 Summary

For the purpose of illustrating the income concepts in the later chapters, this chapter briefly reviews various theories of entity in the literature which are the entity theory, the proprietary theory, the residual equity theory and the enterprise theory. This chapter illustrates that different theories of entity have different implications as to the centre of interests, the relationship between the entity and the various equity holders, and the treatment of returns payable on investments from various parties.

Under the entity theory, the entity exists in its own right. The interests of both the creditors and the stock holders are treated equally. The centre of interest is the entity which suggests that any gains or losses should be considered from the perspective of the entity.

Under the proprietary theory, there is no separation between the business enterprise as an entity and the proprietors. The assets held by the entity are assumed to be owned by the proprietor, and the entity's liabilities are the proprietor's obligations. The centre of the interest in the context of proprietary theory is the proprietor. This suggests that any gains or losses should be considered from the proprietor's perspective.

The residual equity theory is a variant of the entity theory, in that both the residual equity theory and the entity theory view the entity as existing in its own right. However, different from the entity theory, the residual equity theory does not treat all classes of equity holders equally. Rather, it ranks the interests of the residual equity holders higher than those of other financial interest holders.

The enterprise theory can be clearly distinguished from other theories of entity. It views the entity as an institution with a specific system of values and goals in relation to the rest of the society. Under the enterprise theory, the business enterprise is viewed as operating for the benefit of *all* groups of participants, not any one group in particular. The focus is on the relationship between the business enterprise and the society of which it is a part.

CHAPTER 4

THE SERVICE VALUE CONCEPT OF INCOME

4.1 *Introduction*

The term ‘service value income’ refers to the conceptual idea that the income of a business enterprise is the gross economic increases (or decreases) resulting from continued use of services provided by the enterprise’s capital.

Two income definitions can be extracted from the literature to illustrate the service value income concept:

[Income is]...the gain resulting **from the use of capital** or the rendering of personal service as distinguished from the return of capital (Committee on terminology, AIA, quoted by Hatfield, 1927, p.242, emphasis added).

Income appears to be made up of all gross economic increases or decreases... less (or plus) whatever capital, current or fixed, may have been expended, whether **by** disbursement or **consumption** or depreciation, in connection therewith -- except that there is **excluded** from such gross economic increases (or decreases) any fixed-asset ones that, like the realised gross profit resulting from the sale of a machine or the unrealised loss resulting from the decrease in the market value of a building, do **not** directly and necessarily **result from the continued use** of such capital in a fixed-asset capacity.” (Sweeney, 1933, p. 324, emphasis added)

Section 4.2 of this chapter summarises briefly the historical background of this income concept. Evidence suggests that the service value income concept originates in England with its tradition of static land ownership. The recent applications of this income concept can be found largely in the field of taxation law.

The service value income concept has two main features which distinguish it from other income concepts. These features are the source of income and the income production process. They are examined in sections 4.3 and 4.4 below.

Following from the discussions in sections 4.3 and 4.4, section 4.5 outlines the implications of the service value income concept for accounting. In particular, the discussion is focused on three areas of accounting, namely, methods of income determination, the treatment of holding gains or losses, and theories of entity. These three areas are chosen to be discussed because they are the areas on which different income concepts tend to have different implications.

4.2 Background

Evidence suggests that service value income developed from England with its tradition of static land ownership. Alston and Juris (1981) describe this concept as a harvest income concept which is dominated by the thinking of an agricultural economy in England (AIA, 1952).

Alston and Juris (1981) noted that, before the days of classical economists or income taxation, a right to the yield from property, particularly land, often was, and still is, vested in a person other than the owner of the property. The yields from the property were viewed as income from the *usage* of the particular property. Therefore, there was a “harvest concept of income” where income was thought to recur regularly and to arise from sources such as land and properties (Alston and Juris, 1981).

In those days, Alston and Juris (1981) noted, England was essentially a landholding and agricultural community where land was usually bound by a trust and rarely changed hands. Consequently, capital gains arising from the sale of land were also rare. Although there were properties not bound by a trust, sales were relatively rare and variations in value were, in a time of static ownership, of little importance. They did not fall within the meaning of ‘income’, which was viewed as the result of purposeful activity, but were regarded as a result of good luck.

Nowadays, this ‘harvest concept of income’ which is also referred to as the service value concept, is widely adopted by the Courts of the United Kingdom for the purposes of income taxation (AIA 1952). The thinking of an agricultural economy in this concept of

income can be taken as an explanation as to why changes in capital are still not accepted by the courts as taxable income.

4.3 What is the Source of the Service Value Income?

As may be seen from the last section, the main idea of the service value income concept is that income is the yield derived from the usage of properties. Property, which may be used to produce income, is commonly referred to as capital. The source of the income is from the use of that capital. This is evidenced in both the income definitions referred to in section 4.1, in that both Sweeney (1933) and Hatfield (1927) have referred to income as something resulting from the use of capital.

Having acknowledged that ‘use of capital’ is the source of service value income, two questions have now become apparent: what is capital? and what constitutes use of capital?

4.3.1 Capital

The concept of capital adopted in the service value income concept seems to have some economic orientation.

Capital is first defined in the field of economics. It represents wealth in mediate utilisation, that is, wealth that affords gratification only in an indirect way (Clark, 1988). This concept of capital contrasts with what has been termed as ‘consumers wealth’ which is in direct utilisation.

Direct utilisation means a person’s desires are satisfied directly. Indirect or mediate utilisation means that a property cannot satisfy a person’s desires directly, but it can help to produce the means which will satisfy the desires. For example, a person wishes to have a bucket of apples. A ladder (capital) cannot satisfy such desire directly, however, it can be used to reach the fruits in the tree.

Therefore, capital (the ladder) is something useful to produce what a person wishes to receive. This concept of capital can be found in literature where capital is said to consist, for example, of tools, buildings, materials, and food which is the concrete conception. The most important feature of this capital concept is reflected in the fact that the definitions in economics literature concur in striving to express that capital is *productive* (Fisher, 1965). That is, to create income, capital must have utilities to provide desired results.

4.3.2 Use of Capital

Given that capital must have utilities to provide results, it is perceived that utilities are embodied in the capital in the form of service units. Capital is used when service units embodied in that capital are consumed. This can be illustrated by the following example.

A car may provide 20,000 kilometres of running in its life time. The 20,000 kilometres are service units, or utilities, embodied in the car. After 5,000 kilometres of running, the car would only have 15,000 kilometres of service units embodied. The 5,000 kilometres are the service units used up.

It should be noted that service units themselves are not capital. Capital is the profit yielding structure, which is constituted by the assets in which the service units are embodied. In the above example, if the car belongs to a car-rental business, the car is capital to the business, but the kilometers of service units are not capital.

To use capital means to extract, recombine, and consume service units embodied in the capital (Bedford, 1965). There are two effects which may arise from use of capital: economic benefits are derived from the consumed service units, and the number of service units embodied in the assets involved declines. Service value income attempts to measure both of these effects.

Following the above car example, the economic benefits associated with the 5,000 kilometres of running would be the receipts collected from the driver for renting the car. After the running, the car has 5,000 less kilometres of service to perform than before the

running, so the service units embodied in the car have declined. Service value income derived from this car (capital) is the net result of receipts collected and the amount of costs which measure the service units consumed.

The first effect of the use of the capital—economic benefits derived—is recognised in many places in literature. For example, *the Committee on Terminology's* definition of income shown earlier in this chapter, “income is the gain resulting from the use of capital”, clearly indicates that gains arise from the use of capital.

As for the second effect — losing service units embodied in the capital asset --this is recognised in the traditional thought on depreciation. Traditionally, depreciation was considered to measure losses of service units incurred as a result of the use of assets. Below are two example quotations extracted from the literature.

Depreciation has been defined by the Interstate Commerce Commission as the lessening in cost value due to the **smaller** number of **service units** in the property as found than in the same property new (Hatfield, 1927, p.130, emphasis added)

During the nineteenth century, the concept of depreciation emerged as a ‘cost of production.’ Manufacturers’ schedules of the time accounted for the use of tools and machinery when computing the cost of manufacturing engines (Chatfield and Vangermeersch, 1996, p.199).

The above definitions indicate that there is a separation between the service units and the capital assets in which the service units are embodied, in the sense that the consumption of the service units is considered a separate issue from the changes in exchange value of the capital assets. Depreciation measures the service units utilised from the capital assets during the income production process, not a change in the capital’s exchange value.

Being the source of income, the use of capital has an important role to play in the concept of service value income. The idea that capital has service units embodied in it implies that capital is purchased with a view to provide some services to the production process. It is assumed that the capital will provide the same kind of services for many years. The use of capital for these intended services is accordingly an expected activity. As expected activities are manageable, the results which come from them tend to be recurrent and

regular. Therefore service value income, as the result of the use of capital, should be recurrent and regular. That might be the reason that recurrence is thought to be one of the main features of income.

It has been noted that the English courts and many definitions in the accounting literature have emphasised the recurring nature of income (Alston and Juris, 1981, p.147; American Institute of Accountants, 1952). For example, Plehn (1924) explained that income was merely recurrent, consumable receipts.

4.4 *How Income is Produced*

In the last section, it was suggested that income is derived from the use of capital and capital is something which is embodied with service units. In this section, the roles of capital in the income production process are further defined. In particular, this section demonstrates that different kinds of capital produce income in a slightly different way.

There are two kinds of capital which have been referred to in the service value income concept: 'fixed capital' and 'circulating capital'. The distinction is first drawn by Adam Smith (1937, referred to by Meacci, 1989) and is based upon a difference in the nature of services each kind of capital provides (Meacci, 1989).

4.4.1 Fixed Capital

Typically, fixed capital, such as buildings, and tools, have active industrial functions to perform. An active industrial function is to impart utilities from the instrument to other things, for example, a building imparts protection to people. Therefore fixed capital is designed to remain and aid in the production of saleable goods.

As fixed capital's service is to impart utilities to others, income is produced by letting the fixed capital remain in the production process and be consumed until it is gone or forced

to leave (Adam Smith, 1937, referred to by Meacci, 1989). It means fixed capital is what the owner turns to profit by keeping it in his own possession.

4.4.2 Circulating Capital

Circulating capital, such as raw materials and work-in-progress, has passive industrial functions to perform (Clark, 1988). A passive function is to receive utilities from other instruments instead of imparting them. That is, circulating capital undergoes modifications, but modifies nothing. For example, raw materials undergo transformations and modifications, but they do not provide utilities in the production process (Weiner and Bonbright, 1930). Therefore, circulating capital goods are intended for sale, either in their present form or after they have been made up into finished goods (Weiner and Bonbright, 1930).

As circulating capital provides service by receiving utilities, income is produced by circulating capital leaving the production process to circulate (Hatfield, 1927). In other words, the role of circulating capital in the income production process is in receiving service units and being exchanged in the market.

4.5 Implications for Accounting

The previous section discussed the concept of service value income from three perspectives; the historical background, the source of income, and the income production process. It illustrated that the source of service value income is the continued use of capital. In this context, capital is viewed as existing in its physical form. There are two kinds of capital, each produces income differently. The fixed capital produces income by remaining in the production process and imparting service units embodied in them. The circulating capital produces income by receiving the service units and leaving the income production process. Two results may arise from use of capital: the number of service units embodied in the fixed capital declines and economic benefits are derived. The service value income attempts to measure the effects of both.

These features of the concept of service value income have several implications for accounting in terms of theories of entity, methods of income determination, and the treatment of holding gains or losses.

4.5.1 Theories of Entity

In chapter three, the different theories of entity have been discussed, the different views towards the relationship between the entity and proprietors (or stockholders), and the relationship between different classes of equities in the entity.

In respect to the relationship between the entity and its equity holders, the entity theory and the residual equity theory hold that the entity exists in its own right separate from the shareholders or the stockholders. The proprietary theory on the other hand, does not distinguish between the entity and the proprietors. The assets held by the entity are assumed to be owned by the proprietors and the liabilities of the entity are their obligation.

Related to the concept of service value income, it does not seem that the separate existence of the entity is a necessary requirement. As outlined in section 4.1, the service value concept of income originated in England when it was essentially a landholding agricultural community. This was at a time before the development of income taxation. However, it was noted that the concept that business entities have rights and identities on their own first appeared in the development of company law. Accordingly, the service value concept of income seems to have preceded the entity theory. This can be taken as an indication that the concept of service value income does not require the entity having a separate identity from the proprietors.

In respect of the relationship between different classes of equities in the entity, the entity theory suggests that all classes of equities should be treated in a similar manner. The residual equity theory suggests that the interests of the residual equity holders should be ranked higher than those of the specific equity holders whose investment requires specific financial returns in the future. Under the proprietary theory, the proprietor has a central role, therefore his/her interests in the entity is ranked the highest.

Related to the concept of service value income, it seems that the centre of interest is the equity holders, whose return on investment relies on the efficient use of the capital. This is because the service value income concept proposes to report benefits derived from the uses of capital. It implies that income is measured from the perspective of those who rely on the benefits derived from, or the efficiency of, the uses of capital. This is in contrast to the debt holders who merely lend money to the business and derive fixed amounts of interest from the loan. These debt holders' income is not dependent on whether the capital assets have been used efficiently and effectively, but on the liquidity of the business in paying the interest.

4.5.2 Methods of Income Determination

Under the concept of service value income, significant emphasis has been placed on income being something resulting from the use of capital, and that it is different from capital and/or changes in capital. Therefore an important issue in determining service value income is how to distinguish income from capital.

To distinguish income from capital, it has been suggested that capital is like the tree or the land and income is like the fruit or the crop. Capital depicted as a reservoir supplied from springs, income is an outlet stream to be measured by its flow during a period of time (Alston and Juris, 1981). All these metaphors reflect the idea that capital is the provider of the source of income, and income is derived from services provided by the capital.

Applying the above to income determination, it means that income must be a flow resulting and/or derived from the kind of services that the capital is held to provide. For example, a government grant to the proprietors of a shoe factory for protection of local business is not considered service value income to the proprietors, because it does not represent a gain resulting from the kind of services that the capital of the factory was held to provide. Similarly expenditure incurred by the proprietors in obtaining a loan to finance the factory is also not part of income calculation. This is because such expenditure does not represent the flow of services that the capital was held to provide, but a cost in obtaining that capital.

In the past, great efforts have been made to distinguish circulating capital from fixed capital, since the distinction has major implications for the calculation of service value income. If the assets being sold in the market are fixed capital, then the gain or loss arising from the transaction is a capital gain or loss not income. This is because fixed capital is held to remain and impart service units to the income production process, not to be sold in the market. In comparison, if the assets being sold are circulating capital, then the resulting gain or loss is income. This is because the role of circulating capital in the income production process is to receive service units and be sold in the market. Gains or losses derived from selling the circulating capital represent what the capital is held to provide and therefore should be included in income.

4.5.3 Treatment of Holding Gains or Losses

As discussed, under the concept of service value income, for a gain or loss to be recognised as income, it must be a flow resulting or derived from the use of capital, that is, the kind of services that the capital is held to provide. It was illustrated that fixed capital is held to remain in and impart service units to the income production process, it is not held to be sold in the market. Therefore, the implication is that any value changes in the fixed capital are not derived from the use of the fixed capital and thus should be excluded from income. This view is discussed by Weiner and Bonbright (1930) and Alston and Juris (1981) and can be illustrated by the following example used by Clark (1988, p. 29).

A farm may yield \$10,000 worth of wheat a year whether the farm itself is worth ten thousand dollars or a hundred thousand. In this case, the farm represents fixed capital as it provides utilities to the production process, and whatever accrues to the owner of the farm as a result of using those utilities provided, is the income of that farm, irrespective of the farm's value.

The above suggests that *unrealised* holding gains or losses on *fixed capital* should be excluded from income.

Related to *circulating capital*, the concept of service value income seems to imply that *unrealised* market value changes associated with the circulating capital of the entity could be included in income. This is because under the concept of service value income, income must derive from what the capital is held to provide. Circulating capital is held to receive the service units and be sold in the exchange market. Changes in market value of circulating capital have direct relevance to the benefits that the circulating capital could provide to the entity through being exchanged in the market. Accordingly it seems that changes in market value are related to what the circulating capital is held to provide and thus should be incorporated in income.

Moving away from unrealised holding gains or losses to realised ones, if the *realised* gains or losses are derived from *fixed capital*, the service value income concept implies excluding them from income. This is because fixed capital provides services by remaining in and imparting utilities to the income production process. Any gains or losses that may arise from disposals of fixed capital is neither derived from, nor a result of, the kind of services that the fixed capital was held to provide. Such gains or losses should not be included in income.

With respect to *realised* gains or losses associated with the *circulating capital* of the entity, the concept of service value income implies that they should be included in income. This is because the role of circulating capital in producing income is to leave the production process for ultimate exchange in the market. To be recognised as income, the gain or loss has to be derived from, or a result of what the capital was held to provide. All realised gains or losses derived from the circulating capital of the entity are the direct consequences of the circulating capital being sold in the market, and thus are results of what the capital was held to provide.

To sum up, the implications of service value concept of income are that both unrealised and realised holding gains or losses associated with the *fixed capital* of the entity are *excluded* from income. Those holding gains or losses associated with the *circulating capital* of the entity are included in income.

4.6 *The service value concept of income summarised*

The service value concept of income says that income is the benefit derived from continued use of capital. Capital is defined as wealth in mediate utilisation. In the income production processes, services are performed by capital to produce income.

There are two kinds of capital instrument, fixed capital and circulating capital; each is used differently to produce income. Fixed capital imparts utilities to other things. It is therefore intended to assist in the production process. Income is produced from fixed capital that remains in the production process. Circulating capital receives utilities from fixed capital, it is designed to leave the production process and circulate.

The service value income concept has several implications for accounting. First, the entity is not required to be in existence in its own right. Second, the centre of interest should be the equity holders whose return on investment is dependent on the efficient use of capital. Third, income must be a flow resulting or derived from the kind of services that the capital is held to provide. Fourth, both unrealised and realised holding gains or losses associated with the fixed capital of the entity should be excluded from income. Finally, those holding gains or losses associated with the circulating capital of the entity should be included in income.

CHAPTER 5

THE BUSINESS VENTURE CONCEPT OF INCOME

5.1 *Introduction*

The business venture concept of income views income as a reward for undertaking ventures which are risky undertakings and from which returns are expected to be derived.

In this chapter, the term 'venturers' is used to describe loosely the group of equity holders whose return payable on investment is reliant upon the actual outcomes of the venture activities undertaken. It is adopted to avoid confusion over terminology used specifically in the context of a particular theory of the entity. For example, the term proprietor is referable to the proprietary theory.

No definitions of income as such have been identified in the literature that could be used to demonstrate the business venture concept of income. Still, evidence shows that the business venture income concept is the idea that has been behind many older and more recent accounting practices. Section 5.2 of this chapter summarises the historical background of the business venture concept of income, and demonstrates a few applications of the concept in accounting.

This chapter follows the same structure as the previous one, in that, sections 5.3 and 5.4 discuss the concept of business venture income again in two perspectives: the source of income, and the income production process. They are followed by section 5.5 which demonstrates the implications of the business venture income concept for accounting.

5.2 *Background*

According to the records of accounting history, business venture income first appeared under a venture accounting system which was developed in the seventeenth century

(Stamp, 1971). During that time, as a result of expanded commercial activities in some Italian cities, partnerships were formed to share the risks and returns of the long sea voyages undertaken by merchants. The system of “venture accounting” was used to serve the main interest of the merchants which was to determine the surplus remaining at the conclusion of each of their “ventures”, such as when a ship returned (Hendriksen, 1977).

At that time, undertaking ventures was considered very risky, as venturers might never recover their investment. Still, investments were made, as there were expectations that there would be great returns from the ventures which might exceed the value of the investment. The margin between the amount of returns expected from the venture and the value of the investment motivated the undertaking and investment. Some would risk the loss of their properties to gamble for the returns at the completion of the venture, any gain realised being a direct result of their risk taking. From here, the concept of business venture was developed; the venturers considered that what they would receive at the end of each venture a reward to their risk taking (Chatfield and Vangermeersch, 1996).

The business venture income concept has been the idea behind the accounting practices for joint ventures. In early days, the joint venture form of business operation was an association of individuals who united their resources for some specific venture, such as a ship’s voyage (Bedford et. al., 1979). The ventures generally required a large amount of capital and involved risks too great for any one of the venturers to assume in total. Nowadays, business joint ventures are also formed to accumulate capital and to share risks, and the venturers generally have agreements or contracts between them for sharing profits at the end of the ventures (Bedford et. al., 1979). Because of the risks involved in joint ventures, a high return rate is usually expected from the ventures to promote investments. The gain realised at the end of a venture is the reward to the venturers.

Applications of the business venture income concept can be found also in the practice of calculating earnings per share, that is, earnings available to common stock divided by the average number of common shares outstanding (Davidson and Weil, 1983). Earnings-per-share indicates to potential venturers whether it is worthwhile to risk the investment by comparing what could be returned to them with what needs to be contributed. This type of

analogy, that risks of investment is weighed against expected returns, is a reflection of the business venture income concept.

5.3. *What is the Source of the Business Venture Income*

As outlined in the section above, the main idea of the business venture income concept is that income is derived from ventures which are usually associated with high risks, and high expectations of gains. Clearly, it implies that the ventures are the source of income.

As the source of income, venture could also be a period of time. This is because, as businesses have developed into a continuous process, and the venture activities carried on over several accounting periods, it has become impractical to calculate business venture income on a venture by venture basis. In those circumstances, the accounting period itself becomes the venture (Coombes and Martin, 1982). That is to say, if a long period of time is required to complete a venture, income may be calculated at the end of an accounting period when a venture is assumed to be finished involving activities conducted during that period. In that case, income becomes the gain or loss from activities conducted during an accounting period.

Venture, as the source of business venture income, has two important features. First, it includes all events which are part of the undertaking, not just the day-to-day operating activities of the venture. For example, if an asset was used in the venture, and later destroyed by fire, the event of the fire is a part of the venture undertaking. This is because once an asset is purchased, or built, it is exposed to risks of all kinds of disastrous happenings, such as a fire or flood. These events happen in the course of the venture, even though the possibilities of their happening might be very small. Further, the loss arising from the event of fire is one of the consequences of undertaking the venture activities. This is because the asset has been obtained for the purpose of the venture and by losing the asset the venture has incurred a loss. This further proves that the event of fire, although not a normal or regular event, is a part of that venture undertaking. Therefore, unlike the idea of the service value income concept, business venture income is not necessarily derived solely from regular purposeful activities.

Second, a venture is a set of activities which have definite life times, that is, a beginning and an end. This is different from the idea of uses of capital which are continual activities that may carry on forever. It means that while business venture income may be calculated at the completion of a venture, representing the venture's end result, service value income must be calculated on a period by period basis.

5.4 *How is Income Produced*

The income production process basically involves venturers supplying funds, or investments in the venture, which in turn recycles funds back to the venturers, that is, the return on investment is derived (Pence, 1982). In that context, the income production starts from investment, which is the input to the venture and ends with the return on investment, which is the output.

The input to the venture (investment) is explained further in section 5.4.1. It is followed by section 5.4.2 which discusses the output of the venture – return on investment.

5.4.1 Investment

In general terms, 'investment' refers to the total asset value that the venturers invest in a business venture or operation. Two forms of investment have emerged in the process of the development of venture accounting: terminable capital investment and permanent capital investment.

Terminable capital investment precedes the principle of permanent capital investment. It was developed in the early seventeenth century, when a series of ventures were sometimes undertaken by a business organisation (Chatfield and Vangermeersch, 1996). Capital stocks were issued at the beginning of each venture, so that venturers who wished to have a share of the realised returns at the end of the venture could do so by purchasing a certain number of capital stocks. After the venture was completed, any assets left over were distributed to the venturers in proportion to the capital stocks they purchased. The asset division meant that the last main function of capital stocks, which was to provide a basis

for venturers to claim their share of realised assets at the end of the venture, was completed (Chatfield and Vangermeersch, 1996). Therefore, capital stocks were terminated after the asset division.

As commercial activities continued to expand, the concept of terminable capital investment was soon replaced by a new form of capital investment which was established by the principle of permanently invested capital being the total of asset values devoted to the operations of a *continuing* corporation (Paton, 1962)

The principle of permanently invested capital was established in 1657 (Chatfield and Vangermeersch, 1996) when it was found that ships, trading posts, and other long lived assets tended to carry over from one venture to the next. Also, during the seventeenth century, trading abroad developed into a continuous process which required permanent capital, that is investments that would not be withdrawn as long as the business kept operating. From this, followed the logic of permanently invested capital, businesses were beginning to be viewed as going concerns. Instead of dividing assets and income at the end of each venture, 'dividends' were paid out from the corporation from time to time (Chatfield and Vangermeersch, 1996).

The idea of permanently invested capital meant that as unliquidated balances or 'remains' of earlier ventures were merged with later ones, the concept of business venture income also evolved (Chatfield and Vangermeersch, 1996). Originally, business venture income was considered a reward derived from a specific venture. After businesses were developed into continuing operations, business venture income was considered as the total amount of returns derived from many ventures, in various stages of completion, undertaken by a business organisation during an accounting period. The accounting period itself became the venture.

5.4.2 Return on Investment

Originally, in the days of terminable capital stocks, returns derived from a venture were shared among the venturers at the completion of each venture. These returns were physical assets or money that were returned to the venturer from the venture.

As businesses developed into a continuous process, so that many ventures could be undertaken at the same time, the balance of earlier ventures is invested in later ones. Realised returns are no longer distributed after a particular venture undertaking, instead the 'accrued' returns from ventures in various states of completion are credited to the 'retained earnings' account of the business enterprise which undertake the ventures. The total amount credited to the retained earnings account at the end of an accounting period is the business venture income distributable to the venturers.

Under the business venture concept, the test for whether a credit has 'accrued' to 'retained earnings' is to ask whether the credit is available for enjoyment (Zeff, 1978; Coombes and Martin, 1982). Enjoyment could come in two ways. The first way is to have the credit reinvested to the business. By doing that, venturers enjoy having a prospect of return on that further investment. The second way is to have the credit withdrawn by the venturers, through either dividend distribution or selling their investments. By doing that, venturers enjoy being able to use the amount of money converted from the credits for other goods and services which they desire (Hamilton, et. al. 1995).

Being available for enjoyment does not necessarily mean that the credit have to be physically in the hands of the venturers. But it does mean that the venturers have a choice of withdrawing the credit for other uses. Shares traded during the life of a business enterprise carry an imputed interest, or credit, in the retained earnings. The imputed interest can be withdrawn by either the venturer selling his or her shares, because the selling value would have included the value of the imputed interest or by distribution of dividends on the shares. It means that so long as the venturer has an imputed interest in the retained earnings of the entity, he or she would have the choice to withdraw them for

other uses. In that situation, the imputed interest in the retained earnings is considered 'available' for enjoyment by the shareholder.

5.5 Implications for Accounting

The previous sections discuss the concept of business venture income from three perspectives, the historical background, the source of income, and the income production process. It demonstrated that business venture income is derived from ventures which are undertakings associated with risks and expectations of gains at the completion. Venture undertakings are motivated by the expected margin between the amount of returns arising from the venture, and the value of investment. Further, as the source of income, venture undertakings incorporate all events that are necessarily consequences of the venture, not just day-to-day operations of the venture. Accordingly, business venture income, which is derived from the venture undertakings, is not necessarily the result of regular purposeful activities. The test for when income has 'accrued' from the venture is to ask whether the credit is available for enjoyment. Being available means the credit is ready to be distributed, reinvested, or withdrawn by venturers for other uses.

The above features of the concept of business venture income have implications for accounting, particularly in three areas: theories of entity, methods of income determination, and treatment of holding gains or losses.

5.5.1 Theories of Entity

The theories of entity discuss the relationship between different classes of equity holders. Under the entity theory, all classes of equity holders are treated equally. Under the proprietary theory, the interests of the proprietors are ranked higher than the creditors. Under the residual equity theory, the interests of the residual equity holders are ranked higher than those of the specific equity holders who derive fixed amounts of cash disbursements from their investment.

Related to the concept of business venture income, it seems that the relationship between venturers and other equity holders is that the interests of the venturers in the entity are ranked higher than other equity holders. The distinction drawn between the venturers and other equity holders is similar to the distinction drawn between residual equity holders and specific equity holders under the residual equity theory.

Under the concept of business venture income, it is noted that income was considered a reward for taking on ventures which are undertakings associated with risks and prospects of gains. It implies that income is measured from the perspective of those who are willing to take the risks of the venture for the prospective gains.

In a business enterprise that undertakes ventures, the venturers are the main risk takers because their investment is relied on for the expected outcome of the venture, compared to the value of the investment. The venturers either gain or lose depending on the actual outcome of the venture. Their returns are not secured by any means. This is in contrast with those equity holders who invest in the entity on the basis of an agreement or contract made between themselves and the entity, so that future financial returns are relatively fixed and secured. Having a relatively secure return on investment, those equity holders bear relatively fewer risks in ventures undertaken by the entity.

Given that the venturers bear comparatively more risks of the entity's venture undertakings than other equity holders, it seems that income should be measured from the venturers' perspective. The venturers' interests in the entity should be ranked higher than other equity holders. The distinction between venturers and other equity holders seems to be consistent with the distinction between residual equity holders and specific equity holders.

Under the residual equity theory, specific equity was referring to 'interests that require definite fixed amounts of cash disbursements in the future, and include creditors and non-participating preferred stockholders'(see chapter 3). Residual equity holders are those who have the residual claim of the entity's assets after deducting the claims of the specific equity holders. Therefore the main difference between the residual equity holders and the

specific equity holders is that returns on investment repayable to specific equity holders are secured by contracts or agreements made between the entity and the holders of the equities. In that situation, the specific equity holders bear less risk in terms of return on investment than the residual equity holders. This is consistent with the view of the concept of business venture income noted earlier.

Different theories of entity view differently the relationship between the entity and its equity holders. Under the entity theory and the residual equity theory, the entity is viewed as existing in its own right, separate from the stockholders. However, under the proprietary theory, there is no conceptual separation between the proprietors and the entity. The assets held by the entity are assumed to be owned by the proprietors, and the liabilities of the entity are their obligation.

Related to the concept of business venture income, income of the entity is viewed as something available to be enjoyed by the venturers, not the entity itself. This suggests that the distinction between the entity and the venturers is weak. A separation of the entity from its shareholders or stockholders is not a necessary requirement for accounting purposes under the concept of business venture income. This seems to indicate that the concept of business venture income does not reject the proprietary theory.

5.5.2 Methods of Income Determination

Under the business venture income concept, it is the margin between the amount of returns arising from ventures and the value of investment, that is the ultimate force and motive behind the undertakings of ventures. To determine whether the venturer has gained through the investment in the venture, the value of investment must be deducted from the gross amount of receipts derived from the venture. In other words, calculations of business venture income must be based on a return *on* investment, the margin, rather than a return *of* that investment, which is the gross amount.

The features of the business venture income also imply that 'investment' should be measured in financial terms, such as dollar amounts invested, as opposed to physical

terms, such as operating capacities of the assets invested. This is because under the concept of business venture income, income is viewed from the perspectives of the venturers, not the entity. From the venturers' perspectives, investments could be made in several other alternative venture undertakings. The venturers gain if the return from the venture undertaking invested is comparatively higher than the return on investment if they had invested in the alternatives. In this context, investment needs to be measured in financial terms for comparison.

Further to the above, the concept of business venture income suggests that gains or losses derived from unusual or extraordinary events are of a similar nature to other gains or losses arising from day-to-day operations. This is because as the source of income, venture incorporates all events that are consequences of the undertaking, which may include one-off events that are not related to the day-day operation of the entity. For example, in a shoe factory, \$5000 worth of goods is destroyed by fire. Having goods destroyed by unexpected events can be considered the kind of risk that a shoe making venture necessarily involves. The fire in this situation can be considered as a consequence of the undertaking. There is no conceptual distinction between the \$5000 loss resulting from the fire and the losses derived from shoe sales, as both of these losses are reflections of risks in undertaking a shoe making venture.

5.5.3 Treatment of Holding Gains or Losses

In determining the treatment of realised holding gains or losses, the methods of income determination discussed above mean that, *all realised* holding gains or losses derived from the venture activities should be included in income. That is, neither the nature of assets disposed of, nor the circumstances in which the assets were sold, will make a difference to determining whether a gain or loss on disposal should be included in income. A realised holding gain or loss may be recognised as business venture income if it is a consequence of the venture undertaking and reflects the risk of that venture.

Another implication of the concept of business venture income is that *unrealised* holding gains or losses should be excluded from the income calculations. This is because

unrealised holding gains of an asset merely reflect changes in market prices. Without selling the asset concerned, the changes in market prices are not available to be distributed, reinvested, or available to be withdrawn by venturers. Therefore the 'availability of enjoyment test' is not met, and the unrealised holding gains or losses should be excluded from income calculations.

5.6 *The Business Venture Concept of Income Summarised*

This chapter briefly outlines the business venture income concept. It notes that the business venture income concept was developed under the system of venture accounting that emerged in the early seventeenth century. During that time, commercial activities expanded as long risky sea voyages were taken from the Italian cities to the East. To motivate venturers to contribute to these ventures, there were high expectations of reward from the ventures as well as the possibility of loss. Business venture income attempts to measure the realised return on investments arising from the ventures.

Nowadays, as businesses have developed into continuous operations, business venture income measures the total amount of returns derived from many ventures in various stages of completion. The returns arising from the venture undertakings accrue to the venturers when they became available for the venturers to enjoy.

The business venture income concept has several implications for accounting. First, income should be measured from the perspective of the venturers. Second, venturers' interests in the entity should be ranked higher than other equity holders. Third, a separation of the entity from its shareholders or stockholders is not a necessary requirement for accounting purposes. Fourth, measurement of income must be made on the basis that the value of the venturers' investment is maintained untouched. Fifth, investment of the venturers should be measured in financial terms. Sixth, business service value income includes those gains or losses derived from unusual extraordinary events. Finally, while realised holding gains or losses on all kinds of venture assets should be included in income, unrealised holding gains or losses should be excluded.

CHAPTER 6

THE COMPREHENSIVE CONCEPT OF INCOME

6.1 *Introduction*

The concept of income that receives the most discussion in accounting literature is the comprehensive concept of income.

This concept presents the idea that income is the accretion of 'wealth' or 'well-offness' of an economic entity exclusive of the changes resulting from any investment and disinvestment transactions between the entity and the financial interest holders.

Two definitions are extracted from the literature to illustrate the comprehensive concept of income³.

A profit is an increase in **net wealth**. (MacNeal, 1939, p.295, emphasis added)

Net profit (earnings, income or net loss) for an accounting period is the increase (decrease) in owners' **equity**, assuming no changes [by way of additional contributed capital] and no distribution to the owners (Sprouse and Moonitz, 1962, p. 9, emphasis added).

Section 6.2 of this chapter outlines briefly the historical background of comprehensive income. It is followed by section 6.3 which explains the source of comprehensive income.

The comprehensive income concept does not explain why income exists. Instead, it focuses on how income may be measured. Because of this, this chapter has adopted a

³ The term 'profit' is used instead of income in all three definitions of comprehensive income. The use of terminology between profit and income does not change materially the idea underlying each definition, which is that a change in wealth or capital or equity gives rise to income. Sprouse and Moonitz's (1962).definition indicates clearly that the term 'profit' is interchangeable with 'income', and the latter refers to both the increase and the decrease of owner's equity.

slightly different structure from the previous chapters on income concepts. Following on from the discussion on the source of income in section 6.3, section 6.4 summarises the concept's views on income measurement rather than the process of income production, and comments on how different theories of the entity may determine the method of income calculation.

6.2 Background

The development of the concept of comprehensive income is commonly attributed to Hicks (1946), although earlier references to this concept may also be found in the literature. Hicks (1946, p. 172) defined income as "what a person can consume during a week and still expect to be as well off as he was."

Initially, the term 'well-off' in Hicks's (1946) definition of income, was taken as meaning a person's state of wealth measured in terms of his expectations of future cash flows, so that the calculation of income is subjective in nature (Hicks, 1946, p. 177).

Different individuals may have different expectations about their prospective receipts as they expect different prices for the same commodity at particular future dates. Thus A's income is based on A's expectations, B's income is based on B's expectations and so on. Nothing is said about the realisation of these expectations.

Hicks's concept of income has received wide acceptance in accounting literature (Shwayder, 1967; Goldberg, referred to by Glautier, 1972). However, many have also criticised that Hicks's definition of income has been adopted in accounting often without question. They assert that the implementation of Hicks's definition of income is often seriously constrained by practical problems due to the assessment of expectations (Shwayder, 1967) and that Hicks's concept of income is not acceptable for income determination purposes (Chambers, 1966; Edwards and Bell, 1961; Shwayder, 1967).

Because of the subjectivity of Hicks's concept of income, attempts have been made to modify Hicks's definition to avoid measurement of expectations (Hoggett, 1982). These modified versions of Hicks's definition of income translate the term 'well-off' in the

definition into some kind of asset value, which can be measured at a point in time. They suggest that income is the change in asset value measured at two points in time, after having been adjusted for the effects of all investment and disinvestment transactions (Gellein, 1987).

These modified versions of Hicks's definition of income are commonly referred to as 'comprehensive income'. The comprehensive concept of income has shifted the emphasis from the measurement of expectations of the prospective receipts to the calculation of changes in some asset value between two different dates in time (Ma and Mathews, 1979).

6.3 *What is the Source of the Comprehensive Income*

The comprehensive concept of income measures income by changes in 'well-offness' of an entity. In fact, in defining comprehensive income, the terms such as 'well-off', 'wealth', 'net asset value', 'capital' or 'equity' have been used interchangeably by the authors depending on their preferences. For example, in section 6.1, MacNeal (1939) defines income in terms of changes in net wealth.

Although different terminology has been used in defining comprehensive income, this does not change materially the idea underlying each definition. All of the terms used, such as 'wealth', 'capital', and 'net assets', in the definitions, refer to objects which are of value either to the owners, or to the users of the objects concerned. For example, wealth has been defined as things valuable and transferable at a certain price (Sidgwick, 1887, quoted by Chambers, 1995, p. 138). Capital has been defined as, 'those economic goods that service as agents of production in bringing forth more economic goods' (noted by Sweeney, 1933, p. 186), that is, things which have use value. Therefore, it seems that a change in well-offness, or wealth, or capital, or equity, implies a change in asset value. The change in asset value gives rise to comprehensive income.

Changes in asset value, as the source of income, imply that an entity may derive income from all kinds of activities so long as they give rise to changes in asset value. For example,

income may be produced by holding an asset through a period of time during which the value of that asset changes. Therefore, the production of comprehensive income does not necessarily require physical activities, such as modification, transformation, or recombining existing assets, nor does it necessarily involve exchange transactions for the value changes to be recognised. Instead, irrespective of the kind of activities pursued, as long as there is a change in asset value, income should be recognised.

6.4 How is Income Measured

Essentially, the comprehensive concept of income provides a method to measure income by looking at the changes in some kind of asset value of an economic entity. The questions are now, first, what is the object of measurement? That is, should all assets held by an entity be measured? Alternatively, should the measurement include all assets, but deduct the value of certain equities? Second, which asset valuation method should be used?

6.4.1 The Object of Measurement

It has been suggested that the object of measurement under the comprehensive income concept is determined by the underlying theory of entity (Tweedie, 1979). This is because asset values do not exist on their own, but stand to reflect someone's preferences or desires (Lee, 1993). Therefore the measurement of asset value must be taken from a certain party's point of view. The theories of entity determine from whose perspective the asset value should be considered.

Briefly, under the entity theory, the entity exists in its own right. The centre of interest is the entity itself and the interests of the entity are ranked higher than those of others. The entity has the ownership of *all* assets, while creditors and stockholders have equities in the entity. Therefore, from the entity's perspective, a change in value of any assets it holds, is an accretion to its 'well-offness'. The object of measurement is all assets held by the entity.

Under the proprietary theory, the centre of interest is the proprietors. The entity does not exist in its own right. The entity's assets are viewed as belonging to the proprietors, and the entity's liabilities are viewed as being owed by the proprietors. Therefore, the 'well-offness' of the proprietorship is represented by the value of all assets minus the liabilities.

Under the residual equity theory, the entity exists in its own right. However, the focus is on the residual claims to the entity's assets, that is, the residue of the assets that remain after deducting the claims to the assets of the specific equity holders, whose investments require definite fixed amounts of financial returns in the future. Therefore to measure comprehensive income is to measure the changes in value of residual equity. The residual equity, which equals assets minus specific equities or liabilities, is the object of measurement.

In summary, different theories of entity suggest a different focus for income measurement under the comprehensive concept of income. They may be summarised in the following table.

Table 1 – The Object of Measurement under Different Theories of Entity

The Theory of Entity adopted	Entity Theory	Proprietary Theory	Residual Equity Theory
The Object of Measurement	All Assets	All assets <i>Minus</i> Liabilities	All assets <i>Minus</i> Specific Equities

6.4.2 The Asset Valuation Method

There are three main concepts of value in the literature: value in exchange, value in use, and value to the owner.

Value In Exchange and Value in Use

The first two concepts are commonly attributed to Adam Smith (referred to by Godfrey, et al., 1994) who defined 'value in use' as the benefits of the asset derived from uses of the asset, and 'value in exchange' as the benefits of the asset derived from exchanges of the assets for other goods and services.

It should be noted that both 'value in exchange' and 'value in use' are 'generic' terms. That is, they represent families of value concepts, as opposed to just one specific value concept. The term 'value in exchange' represents the family of value concepts which focus on the benefits of assets derived from exchange transactions, whereas the term 'value in use' represents the family which focuses on the benefits derived from uses.

For example, the concept of value in exchange may refer either to market selling value, net realisable value, or to fair value; and the concept of value in use applies to terms such as 'net present value of future cash flow', 'operating capacity', or 'service potential'. That is, there may be different terms or definitions of value which refer to the same valuation concept.

Value to the Owner

While the concepts of value in use and value in exchange are relatively simple and easy to understand, the concept of value to the owner involves complicated comparisons between different values of an asset.

The concept of 'value to the owner' originates from Bonbright (1937, quoted by Ashton, 1987, p. 2) who stated that:

The value of a property to its owner is identical in amount with the adverse value of the entire loss, direct and indirect, that the owner might expect to suffer if he were to be deprived of the property.

Solomons (1966) adapted Bonbright's (1937) idea of valuation, which is in terms of the value of a property to its owner and applied it to valuation of assets held by a firm. By doing that, the firm is assumed to be the owner of the assets under measurement. The familiar valuation rule of 'value to the firm' set out by Solomons (quoted by Ashton, 1987, p. 2) is that

Value to the firm = current replacement cost (CRC), except where $CRC > \text{Expected Net Present Value (EPV)}$, or $CRC > \text{net realisable value (NRV)}$, when value to the firm will equal EPV or NRV, whichever is greater.

Solomons (1966) asserts that the concept of value to the firm is synonymous with expected net present value which is a family member of the value in use concept (noted by Ashton, 1987). CRC and NRV represent the 'close limits' which were used to approximate expected net present value of an item since it was considered that this particular value was too subjective for practical implementation (Ashton, 1987). These 'close limits' were on the upper side CRC and on the lower side, NRV. The underlying logic is that the loss that the owner of the firm has to suffer cannot be greater than the cost of replacing the asset or its services, or less than the sale proceeds that would be realised if the asset were sold (Ashton, 1987).

The above suggests that the concept of 'value to the firm' is a variant of expected net present value. As 'expected net present value' is a family member of the value in use concept, this makes 'value to the firm' a distant family member of the value in use concept. Therefore, any discussions that relate to 'value in use' in the following sections may be equally applicable to 'value to the firm'.

Given the main categories of valuation concepts discussed, the next question is which one of these concepts should be used to measure the comprehensive income of an economic entity.

In the previous section, it was demonstrated that the theories of entity determine the appropriate object of measurement, and different theories bring out a different focus of

attention. The theories of entity also have an important role in choosing the appropriate valuation method for measuring comprehensive income.

If comprehensive income is interpreted in the context of the entity theory, assets of the entity are measured by their operating capacities. This approach to determining comprehensive income is commonly referred to as 'physical capital maintenance' (Tweedie, 1979). Physical capital maintenance is based on the view of the entity theory that the centre of interest is the entity. The primary objective is to keep the firm operating and let it develop. Therefore, it is thought essential to maintain the real value of the firm's assets – the operating capacity, because the firm cannot exist separately without its operation. According to this idea, the main concern for accounting should be to ensure that the distribution of a company's profits does not lead to a reduction in the enterprise's operating capacity (Tweedie 1979).

Under the physical capital maintenance approach to determining comprehensive income, a change in the value of assets held by the entity is excluded from income. This is because under the entity theory the focus is on the entity itself, as opposed to the equity holders. A rise in the value of an asset held by the entity is not seen as a distributable gain to the equity holders, but as an increase in the current measurement of funds invested in the asset's operating capacity (Tweedie 1979). Accordingly, under the entity theory, a change in value of the entity's assets does not change the measurement of the 'well-offness' or wealth of the entity and therefore does not give rise to income (Tweedie, 1979; Sterling, referred to by Lee, 1982).

If comprehensive income is interpreted in the context of proprietary theory, the assets held by the entity are measured by their exchange values. This approach to determining comprehensive income is commonly referred to as 'financial capital maintenance' (Tweedie, 1979). Financial capital maintenance is based on the proprietary theory that the centre of interest is the proprietors. The entity's assets and liabilities belong to the proprietors, as do its gains and losses. The objective of accounting is to account for the proprietor's interest in the entity.

Under the financial capital maintenance approach, a rise in the exchange value of assets held by the entity is included in income. This is because under the proprietary theory, the centre of interest is the proprietor, as opposed to the entity. The proprietor gains if the exchange value of the assets in the entity rise compared with the general rise in prices, as for example, relative to assets in other entities, whose value is rising at a rate slower than the general rate of inflation (Tweedie, 1979). The focus here is on the proprietors who may have alternatives for investment, as opposed to the entity. In this context, value in exchange is clearly relevant for income measurement, as it indicates whether the proprietors gain though holding assets in a particular entity compared to other possibilities. Accordingly, a rise in the exchange value of an asset held by an entity is considered a real accretion to wealth of the proprietors, and therefore may be considered income.

Compared to the entity and proprietary theories, measurement of comprehensive income has rarely been discussed with the residual equity concept in the literature. However, it may be suggested that under the residual equity theory, assets should be valued from the entity's perspective, which implies that the value in use concept should be adopted. There are two reasons for making this suggestion.

First, as outlined in chapter three, the residual equity theory is merely a variation of the entity theory. Although the residual equity theory seems to suggest that the interests of the residual equity holders should be ranked higher than those of the other equity holders in the entity, this should not be taken as an indication that the interests of the entity should be subordinated to those of the residual equity holders. Second, like the entity theory, the residual equity theory accepts the idea that, from the entity's perspective, all financial interests are *obligations*. Here, the entity's perspective is the focus, and the financial interests are considered from the view point of the entity, not from the view point of the residual equity holders.

6.4.3 Summary

The following table summarises the implications of entity theories on the measurement of comprehensive income.

Table 2 – The Measurement of Comprehensive Income under Different Theories of Entity

	Entity Theory	Proprietary Theory	Residual Equity Theory
The Object of Measurement	All Assets of the Entity	Assets – Liabilities	Assets – Specified Equities or Liabilities
The Most Relevant Valuation Method	Value in Use	Value in Exchange	Value in Use

6.5 The Comprehensive Concept of Income Summarised

In this chapter, the concept of comprehensive income is reviewed. In general, comprehensive income is the difference between an economic entity's state of 'well-offness' determined at the beginning of an accounting period and at the end of that period, having been adjusted for the effect of all investment and disinvestment transactions.

This concept of income is commonly attributed to the work of Hicks (1946) which required the measurement of expectations to determine income. Because of the difficulties with measuring expectations, attempts have been made to modify Hicks's definition of income and suggest that comprehensive income should be measured simply by the changes in asset values. The modified versions of Hicks's definition of income were termed in general as "the comprehensive income".

The implications of the comprehensive income concept is that the changes in the assets value provide the source of income and income may be derived independently from the actual activities or transactions conducted by the entity.

This chapter also summarises the views of the comprehensive income concept on income measurement. In particular, the chapter shows how different theories of the entity would highlight a different measurement focus for comprehensive income.

Under the entity theory, the changes in use value of all assets held by the entity may be measured. Under the proprietary theory, income may be measured by the changes in exchange value of all assets less liabilities. Under the residual equity theory, income may be measured by the changes in use value of all assets less specific equities.

CHAPTER 7

THE CONCEPT OF VALUE ADDED INCOME

7.1 *Introduction*

In broad terms, value added income refers to a measure of valuable goods and services produced by all constituent participants of a business entity or industry (Hendriksen, 1977; Godfrey, et al., 1994; Knell, 1986).

Two income definitions can be extracted from literature to illustrate the value added income concept.

In *Terminology of Management and Financial Accounting*, published by the Institute of Cost and Management Accountants, value added income is defined as:

The increase in market value resulting from an alteration in the form, location or availability of a product or service, excluding the cost of bought-out materials and services (quoted by Knell, 1986, p. 7).

Similarly, in Bedford (1956, p. 45), value added income is described as:

The value added or value destroyed by an economic entity in combining resources into a product worth more than the separate resources used to make and sell it.

The value added income concept originated in economics. Section 7.2 of this chapter outlines briefly the historical background of the value added income concept. It notes that the value added income concept first appeared in the second half of the seventeenth century. The recent applications of this concept can be found in the system of national accounting, the development of which is commonly attributed to Keynes (1936).

The value added income concept differs from other income concepts mainly in two areas: the source of income, and the income production process. They are discussed in sections

7.3 to 7.4 respectively. Section 7.5 outlines the implications of the value added income concept for the three aspects of accounting, that is, theories of entity, methods of income determination, and treatment of holding gains or losses.

7.2 Background

The value added income concept originated in economics. Abraham (1969) notes that the development of the value added concept started from the second half of the seventeenth century, when the English “political arithmeticians” Sir William Petty and Gregory King, were concerned with totalling up “the income of the people” from *economic activity*. The meaning of economic activity is outlined in section 7.3.

As its name implies, the value added concept income focuses on measuring value created by an entity and it has been viewed as an indicator of the social performance of the entity (Suojanen, 1954). The emphasis of this concept is not on whether pecuniary benefits can be derived by a particular interest group of the entity, rather it reports the performance of the entity in terms of its contributions to the progress of the economy.

The value added concept has been used in the development of national accounting by economists to measure the progress and state of a nation’s economy. The development of national accounting is most commonly attributed to Keynes (1936) who devised the basic concept of aggregate income for a nation using the value added concept.

After the great depression and World War II the Keynesian revolution in economic thought led to the system of national accounting functioning as the nation’s bookkeeping system. This system reports periodically on the state of the economy (Myron, 1964). As an application of the value added income concept, the system of national accounting measures wealth created and depleted during a period of time, and is relatively less concerned with the balance sheet in the way that the accrual accounting system is concerned.

More recently, attempts have been made to devise a system of corporate value added statements which focus on value created and distributed by an entity (Burritt, 1986). Corporate value added reporting was first suggested in the USA during the 1920s (Knell, 1986). However, it is not until the 1950s and 60s that the value added approach to financial reporting is adopted by a number of United Kingdom companies (Knell, 1986). *The Corporate Report* published by the Accounting Standards Committee in August 1975 makes an important contribution to the development of value added statements. Nowadays there are both supportive and skeptical commentaries made on the subject (Burrit, 1986).

7.3 What is the Source of the Value Added Income?

The above section notes that value added income focuses on performance of an entity in terms of its contributions to the progress of the economy. This section explains from what source an entity may provide the contributions.

It is thought that an economy progressed through valuable, or desirable goods and services being brought into existence, and that this is achieved by conducting economic activities (Edey and Peacock, 1954). Applied to an economic entity, it means that, by conducting economic activities, the entity is able to produce desirable goods and services; and by so doing, the entity contributes to the progress of the economy. Clearly, under this concept, the source of income is economic activity.

There seems to be no agreed precise definition for 'economic activity'. While Sir William Petty and Gregory King in the second half of the seventeenth century viewed 'economic activity' as involving any activity aimed at satisfying peoples' wants through exchange, others try to restrict it to a narrower sense such as agriculture, and those forms of activity that result in tangible goods (Abraham, 1969; Fisher, 1965; Bedford, 1965).

In any case, the consensus in the literature seems to be that economic activity results in valuable goods and services being brought into existence (Edey and Peacock, 1954). However, this should not be taken as meaning that a commodity has to be made for the activities concerned to be defined as 'economic activity'. It is thought that economic

activity may also be production to move a commodity already in existence – perhaps a natural gift of nature (for example water for energy) – to another place, or to hold it through time, if thereby value is added (Edey and Peacock, 1954).

7.4 How is Income Produced?

By conducting economic activity, value is produced or added because valuable goods and services are brought into existence (Edey and Peacock, 1954). This section outlines the process of value production.

Descriptions of the value added income production process can be found in the two income definitions highlighted in section 7.1. *The Institute of Cost and Management Accountants'* definition suggests that through a process of “alteration in the form, location or availability of a product or service”, income is produced (quoted by Knell, 1986, p.7). In similar terms, Bedford (1956, p. 45) states that value is added, and thus income is produced by “combining resources into a product worth more than the separate resources used to make and sell it.”

These descriptions are based on the idea that value measures the extent to which human desires are satisfied with the goods and services produced (Edey and Peacock, 1954). The more the goods or services can satisfy, the more valuable they become. Therefore, if through a certain modification or transformation process, a particular good or service becomes more desirable, value is added. This is a general description of the income production process.

In specific terms, the production process of value added income may be described by using the following examples. The first example, extracted from Cox (1979, p. 2), illustrates how value is added in the context of a manufacturing firm. The second example shows how value is added in the context of a service provider.

Example One

A furniture factory turns raw timber into fine chairs. It adds value by activities because chairs satisfy human wants directly and are considered more valuable than the tree trunks from which they are made. In this case, the factory turns labour, plus the cost of raw material and other expenses into valuable commodities. The difference between the value of the chairs created and the cost of bought-in items for making those chairs, is value added by the factory.

Example Two

A restaurant adds value to raw food by cooking it and serving it to customers, who pay more than if they had bought the raw food and cooked it themselves. Although the service leaves no trace once it has been used, nevertheless it creates value as it satisfies the customers' desire for not having to cook for themselves. The extent of satisfaction that the preparation and serving of the food may give is greater in degree than that given by the raw ingredients. The difference is the value added by the restaurant.

The above examples show that, the production of value added income involves the process of altering, combining, or transforming existing resources into goods and services that are of more value to society.

Value, in this context must involve human satisfaction. Without human satisfaction, even if some considerable effort has been put into the activity, no value is generated (Knell, 1986). For example, the manufacture of a particular product may require considerable effort on the part of the workers and managers. If nobody wants the product, no value has been generated, as there has been no customer satisfaction. Therefore, value, in this context, shows how desirable the commodities are to the customers (Cox, 1979).

7.5 Implications for Accounting

The previous sections discuss the concept of value added income concept from three perspectives, the historical background, the source of income and the income production process. It was demonstrated that value added income is a measure of the contributions of an entity to the progress of the economy in terms of the value of desirable goods and services it produced. Value, in this context, measures the extent to which human desires are satisfied with the goods and services produced. The source of value added income is economic activities, meaning activities that result in valuable goods and services being brought into existence. Income is produced through a process of altering, combining, or transforming existing resources into goods and services that are of more value to society.

The above features of the concept of value added income have certain implications for accounting, particularly in respect of theories of entity, the methods of income determination, and the treatment of holding gains or losses.

7.5.1 Theories of Entity

It has been suggested that the concept of value added income is related to the ideas of enterprise theory (Suojanen, 1954).

Under enterprise theory, an entity is seen as an institution consisting of groups of participants, including capital providers and employees of the entity (Knell, 1986; Cox, 1979), or even the government (Suojanen, 1954; Burritt, 1986). Suojanen (1954) explains that, if the entity is considered to be an institution, as the enterprise theory suggests, its operation should be assessed in term of its contribution to the flow of output of the community. The purpose of the value added concept of income is to measure this flow, that is the flow of valuable goods and services produced by the groups of participants of the entity.

Both enterprise theory and the value added concept of income imply that the entity has a role to play in society. Enterprise theory views the entity as an institution which cannot

exist apart from the society of which it is a part and which gives meaning and relevance to it. The value added concept of income is consistent with the enterprise theory, in that it proposes to measure the entity's contribution to the progress of the economy and thus implies that the entity has a role to play in the economic development of society (Suojanen, 1956).

7.5.2 Methods of Income Determination

It was demonstrated that the concept of value added income is concerned with measuring the entity's performance in terms of the wealth generated by utilising the available resources of the entity. As the focus of the concept of value added income is on the performance of entity, the measuring of the entity's assets and liabilities is less important than reporting the flow of output, that is the goods and services produced. Therefore, the balance sheet is less significant to the concept of value added income than it is to other income concepts previously discussed.

As an indicator of the entity's social contribution, the concept of value added income implies a measurement of both the value of goods and services destroyed by the entity as well as the value created for the purposes of measuring income. It is the net amount, not the gross amount of contribution that should be measured. For example, if economic production uses up valuable material, supplies, fuel, and electric energy, the total economic value of the items destroyed in the production process are deducted from the value of output created. Therefore, the basic formula for calculating value added income is, value of output created, less the value destroyed in producing that output (Cox, 1979).

It was noted earlier that, value, in the context of value added income, measures the extent to which human desires are satisfied with the goods and services produced. Accordingly, it appears that some valuation methods, such as value-to the owner, net- present-value, and value-in-use, are not appropriate for using in measuring value added income. This is because those valuation methods measure the benefits arising from an asset from the perspective of the owner, or the entity, but not from the perspective of society as a whole. On the other hand, valuation methods such as current market buying or selling value,

reasonably reflect the market demand for, and the desirability to society of, the goods and services under measurement. Therefore, they may be more appropriate for use in the context of value added income.

7.5.3 The Treatment of Holding Gains or Losses

The previous section demonstrates that value added income is to be measured by the value of goods and services produced, deducting the value destroyed in production. The value could be determined by current market values. It implies that the calculation of income is confined to the valuation of goods and services produced and destroyed. Changes in value of other kinds of assets do not come into the calculation of value added income. This means that holding gains, realised or unrealised could arise only from goods and services produced, not from other kinds of assets, because other assets are not measured for income calculation purposes.

For example, the accounting period for a shoe manufacturer is from 1 April 2000 to 31 March 2001. During November 2000, \$10,000 worth of shoes are produced, but not sold. At the balance date of 31 March 2001, these shoes are valued at \$12,000. Therefore, there is an unrealised holding gain of \$2,000. It will be included in the calculation of value added income because the gain relates to the goods produced during the accounting period.

In the above example, if the shoe manufacturer had purchased a shoe-making machine, value changes of that machine, unrealised or realised should not be included in the value added income calculation. This is because the shoe-making machine is not the goods or services produced by the manufacturer, but is used in producing those goods and services. The concept of value added income has little concern with the valuation of balance sheet assets, and confines the income calculation to the valuation of goods and services produced or destroyed. Accordingly, the value changes of the shoe-making machine should not come in the value added income calculation on the basis that they are not derived from goods and services produced and destroyed.

7.6 The Value Added Concept of Income Summarised

In sum, value added income is a measure of valuable goods and services created by the groups of participants in an entity. The valuable goods and services are produced by economic activities, the source of income. Economic activities produce income by modifying, transforming, and recombining existing resources into something that is of more value to society.

The features of value added income have several implications for accounting. First, the entity is an institution which has a role to play in society, and income is the measure of the entity's contribution to society. Second, the balance sheet is less significant to the concept of value added income as it is to other income concepts previously discussed. Third, the basic formula for calculating value added income is: value added equals value of goods and services created less value of goods and services destroyed. In that, the value of goods and services created or destroyed may be measured by current exchange values. Fourth, holding gains, realised or unrealised, are relevant for income recognition only if they arise from goods and services produced.

CHAPTER 8

ANALYSIS

8.1 *Introduction*

The previous chapters demonstrated various concepts of income in the literature, each indicating different views as to the source and production process of income, and having different implications for accounting. This chapter identifies and analyses the income concepts underlying Johnson and Lennard's (1998) and Cearn's (1999) proposals for reporting financial performance.

To identify the income concepts, the four theoretical concepts of income discussed in the previous chapters are first summarised in section 8.2. Section 8.3 then identifies and analyses the underlying concepts of income by comparing the features of concepts of income discussed and summarised in table 3 with the features of the proposals.

8.2 *The Income Concepts Summarised*

There are four concepts of income discussed in the previous chapters. They are the concept of service value income (CSVI), the concept of business venture income (CBVI), the concept of comprehensive income (CCI) and the concept of value added income (CVAI). The features of these income concepts are summarised in table 3 in respect of the features discussed: the nature of income (row 1), the source of income (row 2), the income production process (row 3), the underlying theory of entity (row 4), the implications for the method of income determination (row 5), and the implications for the treatment of holding gains or losses (row 6). The discussion in this chapter is connected to table 3 by references to the column and row numbers. For example 'column 1 row 5' refers to the method of income determination of the service value income concept in table 3.

Table 3 - The Four Concepts of Income Summarised

		(1) The Concept of Service Value Income	(2) The Concept of Business Value Income	(3) The Concept Comprehensive Income	(4) The concept of Value Added Income
The Nature of Income (1)		Economic benefits resulting from continued use of capital	Reward for undertaking risky ventures	A measure of changes in asset value	Wealth created by constituent participants of an enterprise
The source of income (2)		Uses of capital	All events that are consequences of the ventures undertaken by the entity	All activities or events that give rise to changes in asset value of the entity	Economic activities, meaning the activities which bring into existence valuable goods and services
How is income produced (3)		Fixed capital remains in the production process and imparts service units Circulating Capital receives service units and leaves the production process	Venturers invest in a venture which in turn recycles funds back in the form of credits available for enjoyment.	Not Discussed	Existing resources altered to produce a more desirable product or service
Implications for Accounting	The Theories of Entity (4)	<i>The centre of interest</i> is the equity holders those return on investment relies on the efficient use of capital <i>Entity's separate existence</i> is not necessary	<i>The centre of interest</i> is venturers <i>The entity's separate existence</i> is not necessary	Could adapt to the proprietary theory, the entity theory, or the residual equity theory <i>Entity theory</i> : Physical capital maintenance, changes in use value of all assets	Enterprise theory Entity is an institution operating for the benefit of all participant groups Emphasis the entity's role in society
	Method of Income Determination (5)	Income must be derived from uses of capital	Venturers' investment valued in financial terms Value of investment must remain untouched	<i>Proprietary theory</i> : Financial capital maintenance, changes in exchange value of all assets less liabilities <i>Residual equity theory</i> : changes in use value of all assets less specific equities	Value added income equals value of goods and services created less value of goods and services destroyed The balance sheet is less of concern
	Treatment of Holding gains or Losses (6)	<i>Include in income</i> – realised and unrealised gains/losses on circulating capital <i>Excluded from income</i> – realised and unrealised gains/losses on fixed capital	<i>Include in income</i> -- All realised holding gains/losses <i>Exclude from income</i> -- All unrealised holding gains/losses	No strong distinction between realised and unrealised holding gains/losses	<i>Include in income</i> -- gains/losses on goods and services produced in the accounting period

From Table 3, it may be seen that the CVAI contrasts clearly from other income concepts. According to this concept, the entity is an institution that operates for the benefit of all participant groups, including not only the finance providers, but also employees and the government too (column 4, row 4). The scope of income measurement under the CVAI is wider than other income concepts in the sense that it measures the entity's contribution to society whereas other income concepts only measure the benefits accrued to a particular group of equity holders (column 4, row 4). Further, as the CVAI focuses on measuring the entity's performance in terms of wealth created or the output flow to society, the balance sheet is of less concern to the CVAI than it is to the other income concepts (column 4, row 5).

Among the rest of the income concepts in the table, that is, the CSVI, CBVI, and the CCI, the CSVI is distinguished from others mainly by its ideas on capital, uses of capital, and how income is produced. Unlike the other income concepts, the CSVI sees capital as existing in a physical form, as 'tools', or assets embodied with service units (column 1, row 2). Income must be derived from consumption or using up of these service units (column 1, rows 2 and 5). The CBVI and CCI view capital³ as an amount invested in an entity that may be assessed by the application of certain valuation rules to the measurement of assets and liabilities (column 2 row 5; column 3, rows 4 and 5). Income may be derived from all kinds of activities conducted by the entity (column 2, row 2)

The CCI is distinguished from other concepts because of its flexibility and adaptability. Effectively the CCI is a concept of income measurement that offers little discussion on the source and production process of income. It simply measures changes in net asset value of an entity, and these changes may result from all kinds of activities (column 3, row 2), including those that are considered sources of income under CBVI and CSVI concepts. Measurement of comprehensive income is adaptable to various theories of entity and

³The term 'capital' has been used interchangeably with terms such as 'wealth' or 'investment' of the entity. In the table, under the CBVI, the meaning of 'investment' may be used to interpret capital under that concept. Similarly, under the CCI, the meaning of 'well-offness' may be used to interpret capital under that concept.

valuation systems (column 3, row 5) whereas other income concepts do not seem to allow for such flexibility. Under the CSVI, income results from consumption of capital. Capital is viewed as existing in a physical form, embodied with utilities (column 1, row 2). Therefore the CSVI could only fit with a theory of entity and a valuation concept that measures values capital by their utilities and measures the effect of capital consumption, for example, by depreciation. Under the CBVI, income is considered as return on the venturer's investment, and the venturer's investment is measured in financial terms (column 2, row 5). This implies that the CBVI could only fit with the theory of entity and the valuation concept that values investment in financial terms.

Unlike the CCI, the CBVI and CSVI focus on the ideas about source and production process of income (column 1 row 2 and 3; column 2 row 2 and 3). Their views on income measurement are limited and are mostly drawn from what is implied by the source and production process of income (column 1 row 5; column 2 row 5).

Because of the flexibility and adaptability of the CCI in respect of income measurement, depending on the adopted settings of the CCI, it seems that measures of either the CSVI or CBVI could potentially be a subset of the CCI. The CSVI views capital as a combination of utilities (column 1, row 2), which implies that assets be measured on the basis of use values. The CCI can be adapted to measuring use value in the context of both the entity theory and the residual equity theory (column 3, row 5). The CBVI measures investment in financial terms (column 2, row 5). To that extent, the CBVI seems to be consistent with the CCI interpreted in the context of financial capital maintenance (column 3, row 5).

To sum up, comparing the four concepts of income previously discussed, the CVAI can be clearly distinguished from other three concepts, because it emphasises the entity's performance in relation to the society and is relatively less concerned with the balance sheet. Among the rest of the income concepts, that is the CSVI, the CBVI, the CCI, the CCI clearly stands out as the most flexible concept. It may be adapted to suit different theories of entity. Further, it seems possible that measures of CSVI and CBVI can be incorporated with in the CCI.

8.3 The Income Concepts Underlying the Proposals

Based on the income concepts discussed in the previous chapters, which are summarised in section 8.2, this section identifies the concepts of income underlying the two special reports released by the G4+1 on reporting financial performance: Johnson and Lennard (1998) and Cearn's (1999).

Johnson and Lennard (1998) and Cearn's (1999) discuss two main aspects of reporting financial performance. First, whether all financial performance should be reported in a single statement, and second, how the financial performance items should be classified.

The proposals made by Johnson and Lennard (1998) and Cearn's (1999) in respect of each of the above aspects, is discussed below to identify the underlying income concepts.

8.3.1 Whether all Financial Performance Should be Reported in a Single Statement

Both Johnson and Lennard (1998) and Cearn's (1999) agree that there should be *a single performance statement* that will encompass all changes in equity other than those derived from transactions between the entity and the owners (shareholders) (Cearn's, 1999, p. iii).

Johnson and Lennard's (1998) main supporting argument for the single performance statement approach is that such a statement summarises *all* aspects of recognised financial performance, and highlights their relationship to one another (Johnson and Lennard, 1998, paras 3.15-3.16).

In similar terms, Cearn's (1999) argues that the single performance statement approach goes some way towards a clearer presentation of the impact of transactions and other events on financial performance, completing the picture given in the income statement by drawing together *all* recognised gains and losses (Cearn's, 1999, para 2.3).

It is intended that the single performance statement will report what is termed as the 'financial performance' of the entity. The meaning of 'financial performance' is discussed in Johnson and Lennard (1998). In that, Johnson and Lennard (1998) first acknowledge the existence of several definitions of 'profit' or 'income'. After that, Johnson and Lennard (1998) state (paras 1.10-1.13):

One notion of profit or income is reasonably familiar. That notion is that the over-all profit or income for a period is equal to the change in recorded equity (net assets), after adjusting for transactions with owners. That amount...may be referred to by terms such as 'comprehensive income'....That aggregate notion of profit provides a useful benchmark for comparison as a general indicator of performance because no items affecting wealth of the owners of the enterprise are left out.... Many of the terms generally used to discuss income tend to be used in a more restricted sense than the total of all changes in equity. For example, terms such as 'profit' and 'income' are sometimes used to refer to the amount earned from operations... For that reason, the term 'financial performance' is used in this paper to refer to all recognised (recorded) changes in equity other than those resulting from transactions with owners in their capacity as owners, ... financial performance is interpreted in the context of the maintenance of financial capital rather than physical capital. (emphasis added)

From the above, it is clear that Johnson and Lennard (1998) intend to define 'financial performance' in terms of comprehensive income interpreted in the context of financial capital maintenance.

It was shown in section 8.2 that the theoretical comprehensive income concept, income may be determined under various theories of entity. The concept of financial capital maintenance is consistent with the approach under the proprietary theory. When financial capital maintenance is adopted, income is measured by changes in exchange value of all assets less liabilities. This seems to be consistent with the above definition for Johnson and Lennard's (1998) financial performance.

Unlike Johnson and Lennard (1998), Cearns (1999) does not define financial performance. Rather, she avoids discussing the meaning of financial performance by stating that:

This paper does not attempt to provide a definitive answer to the question of what constitutes financial performance. Rather, it seeks a framework within which financial reporting can develop to satisfy the increasing demands being made upon it (para 1.3).

Despite the apparent attempt to avoid further defining 'financial performance', Cearn's (1999) implies that 'financial performance' should be interpreted in terms of changes in net assets of the entity.

On occasion, accounting has responded to new financial reporting challenges by recognising certain **changes in net assets** but excluding them from the income statement.... This has enabled one aspect of the event to be highlighted without disturbing the traditional presentation of the income statement. The result has been that, although the effect of the event on net assets is shown clearly, the change itself (ie the gain or loss) is not disclosed as an aspect of financial performance. Because these items of financial performance are not included in the income statement, they tend to be obscured in equity (reserve) movements.... The members of the G4+1 agree, however, that all components of recognised performance should be reported and described as components of performance. (Cearn's, 1999, paragraphs 1.11-1.12) (emphasis added)

Further, Cearn's (1999, p. 6) makes it clear that the performance statement is intended to report 'comprehensive income' of the entity.

Section I of this paper proposes that all recognised gains and losses (including revenue and expenses) should be reported in a single performance statement. This approach to reporting is variously referred to as ..'comprehensive income'.

Cearn's (1999) intention that the single performance statement should report comprehensive income of the entity is consistent with Johnson and Lennard's (1998) definition of 'financial performance'. However, she does not mention financial capital maintenance.

8.3.2 How the Financial Performance Items Should be Classified

Based on the single performance statement approach, Johnson and Lennard (1998) suggest reporting components of financial performance within the single performance statement on the basis that (para 3.20 – 3.22):

Financial analysts and other users of financial statements are primarily interested in information about financial performance as a means of forming expectations **about the future cash flows of a particular business enterprise**, particularly the amount, timing and likelihood of those future cash flows.... Users base their forecasts about an entity's future financial performance and its future cash flows on its past performance. Their actions based on those forecasts are subsequently reflected in the market prices of securities such as equity shares... Information conveyed by **components** of financial performance has the potential to be more useful than information that is conveyed by overall summary measures that include numbers of heterogeneous items. Because components

reflect more homogeneous classes of items, they have characteristics that are more similar in terms of continuity or recurrence, stability, ... and thus **are likely to have similar implications in terms of their predictive value....** (emphasis added)

Based on this, it seems that the primary reason, for reporting components within the single performance statement, is to help the users to predict the entity's future cash inflows. Based on the assessment, the users can then make decisions about their investments in the entity.

Having concluded that components of financial performance should be reported, Johnson and Lennard (1999) discuss several alternatives for classifying components of financial performance. These alternative are drawn from various sources including research about what users apparently find useful, recommendations from user groups, and classification dichotomies that have been suggested by users and standard setters. The examples of the alternatives considered include separating the unrealised gains and losses from realised ones (para 4.8, para 4.27), separating operating or trading activities from gains and losses from holding assets and liabilities; and separating financing activities from other activities (para 4.7) as well as other suggestions.

Johnson and Lennard (1998) report the G4 +1's agreement that, instead of simply developing one of these dichotomies, financial performance should be classified into three components: the operating activities, the financing and other treasury activities, and the 'other' gains and losses component. However, Johnson and Lennard (1998) do not state their interpretations for these three components or how items should be assigned to each of the three components. Rather, they note that the contents of the three components required further discussion (paragraph 6.3).

Cearns (1999) develops this three-way classification theme of operating, financing and treasury, and 'other' gains and losses. In that, Cearns (1998) emphasises the role of financial performance reporting in providing information that is useful in making predictions about the entity's future performance in terms of generating cash inflows (para 1.6 –2.8).

A key objective of financial reporting is to provide information that is useful in making predictions... of the amount, probability and timing of future cash flows.... Reporting the components of financial performance entails a description of the components as well as disclosure of their amounts. It follows that **providing information on the components** of financial performance **assists users...to make predictions** about [the entity's] future financial performance.... (emphasis added)

The above seems to be consistent with Johnson and Lennard's (1998) view that reporting components of financial performance should help the users to predict the entity's future cash inflows. Based on this, Cearn's (1999) proposes that the operating component of the three-way classification theme should report gains and losses derived from activities that are central to the entity. The financing component should report gains and losses derived from financing or treasury activities; and the 'other' component should report gains and losses derived from activities that are remote from the central operations of the entity (Cearn's, para 2.9 – 2.10).

Cearn's (1999) does not discuss in detail the characteristics of the items that would fall into the financing component, claiming that the content of this component is still subject to development. Cearn's (1999) focused on the distinctions between the operating items and the 'other' gains and losses. In other words, Cearn's developed one of the dichotomies mentioned by Johnson and Lennard (1998) rather than the three-way classification scheme the G4 + 1 seeks to develop.

Cearn's's (1999) two-way distinctions between the operating items and the 'other' gains and losses suggests that the operating component seems to measure the service value income of the reporting entity. These distinctions and indications of service value income are discussed in section 8.3.2.1. Moving away from two-way to three-way distinction proposed by the G4 + 1, it seems that if the financing component were fully developed and added on to the existing operating and the 'other' components, the operating component in this context would be prevented from reporting service value income. This is discussed further in section 8.3.2.2.

8.3.2.1 The distinctions between the operating component and the 'other' component

Cearns (1999) suggests that the characteristics typical of operating items and those that are typical of other gains and losses may be arrayed as shown in table 4 (paragraph 2.12)

Table 4 – Characteristics of Operating and Non-operating Items

Characteristics more typical of operating items	Characteristics more typical of other gains and losses
Operating activities	Non-operating activities
Recurring	Non-recurring
Non-holding activities	Holding activities
Internal events (eg value adding activities)	External events (eg price changes)

Cearns (1999) explained that none of the characteristics described above should be seen as a classification criterion to the exclusion of the others. Rather they are intended to act as a guideline so that if an item of financial performance *predominantly* has the characteristics of an operating item, it may be included in the operating component. Therefore, it is possible that items of one particular component will have some characteristics of the 'other' component.

It was noted earlier that, the total financial performance in the proposed single performance statement seems to follow the CCI. To the extent that the components of the performance statement were developed on a conceptual basis, there should be a concept of income underlying the contents of the components. This concept of income must be capable of being incorporated within the CCI.

As was discussed in section 8.2, the CCI is adaptable to different settings of income measurement. Depending on the adopted settings of the CCI, incorporating measures of either the CSVI or CBVI within the single measure of CCI seems possible. Therefore, to

the extent that the components of the performance statement were developed on a conceptual basis, either the CSVI or the CBVI could be the underlying concept of income.

It seems rather unlikely that the measures CVAI could be fitted within the CCI for two main reasons. First, it was noted that the scope of income measurement under the CVAI is wider than the CCI. Therefore it seems that the value added income measuring from a wider perspective cannot be fitted within the comprehensive income, measuring from a narrower perspective. Second, as a measure of performance, the CVAI is less concerned with measuring assets and liabilities of the entity. This is inconsistent with the CCI which is essentially a measurement theory that suggests measuring income on the basis of asset measurements.

Based on the above, to identify the underlying concepts of income under the operating-other split, each of the characteristics outlined above in Table 4 is compared with the features of only the CSVI and CBVI as summarised in Table 3.

The Operating and Non-Operating Activities Distinction

An important characteristic of items in the operating component is that they are associated with the 'operating activities' of the entity. Cearn's (1999) interprets 'operating activities' in terms of 'central' or day-to-day' activities of the entity that can be monitored through active management, such as sales, compared with those activities that are less manageable and more remote from the business operation of the entity, such as changes in value of a manufacturer's factory properties (para 2.9, 2.10).

By separating the items of operating activities from those that are not, Cearn's (1999) implies a conceptual distinction between the operating activities and non-operating activities of the entity. This conceptual distinction does not seem to relate to the CBVI. The CBVI does not select the entity's operating activities and treat them differently from non-operating activities. Instead, venture activities, as the source of income incorporate not just the day-to-day operations of the venture, but all events that are the consequences

of the undertaking. There is no conceptual distinction between the gains or losses that are derived from operating activities of the business venture and those that are not.

The implied conceptual distinction which Cearn's (1999) makes between operating activities and non-operating activities seems consistent with the CSVI. The features of 'operating activities' discussed above are similar to the features of 'uses of capital', the theoretical source of income under the CSVI. Under the CSVI, use of capital is distinguished from other activities because it is the kind of activity that gives rise to income. It is considered that assets of an entity are purchased with a view to provide a certain kind of services to the production process, those assets will provide the same kinds of services for many years. Uses of capital for these services are expected activities and accordingly may appear to be regular, manageable, and thus may be referred to as what Cearn's (1999) describes as the 'operating' activities of the entity.

The Recurring and Non-Recurring

Recurrence is another feature of operating items outlined in Cearn's (1999), yet Cearn's (1999) does not elaborate on the meaning and implications of items being recurrent.

The recurring feature does not seem to relate to the CBVI in any way. Under the concept of business venture income, income includes one-off gains or losses that may be a pure result of luck. This is because the venture activities, as the source of income, incorporate all events that are part of the undertaking, not just the day-to-day operation of the venture. The business venture income may be results of one-off venture activities and thus is not necessarily recurrent.

Having rejected the CBVI, the CSVI may be used to explain the idea underlying the recurring and non-recurring distinction. Under the CSVI, capital is purchased with a view to provide certain kinds of service to the income production process. There is an assumption that the capital structure of the entity is fixed and will always provide the same kind of services. The use of capital, as the source of income, is the constant flow of the services provided by the fixed capital structure and therefore it may produce results that

are perceived as regular and recurrent. This perhaps explains why service value income and operating items as proposed by Cearn's (1999) is associated with the nature of recurrence.

The Holding and Non-Holding Distinction

Cearn's (1999, p. 22, footnote) defines holding gains and losses in terms of:

Holding gains and losses arise from price changes during the time that an asset or liability is held by the reporting entity. They do not include profits or losses arising from the use of that asset or liability.

The above extract clearly indicates that the idea underlying the distinction between holding gains or losses and non-holding gains or losses is to distinguish between value changes of an asset and gains or losses arising from uses of that asset.

Cearn's (1999) applied this idea to distinguish between depreciation and impairment and the gains or losses derived from value changes of fixed assets.

Cearn's (1999) defines depreciation in terms of uses of the asset by the entity, and impairment in terms of accelerated depreciation, which may result from factors such as technological obsolescence or from physical wear (para 3.8-3.9). Cearn's suggests that this type of costs, that is the costs that relate to uses of the fixed assets, are to be reported in the operating component. This is in contrast with the gains or losses derived from price changes of the fixed assets which are to be reported outside the operating component. In this way, costs that relate to the use of the fixed assets are clearly separated from gains or losses that relate to the assets' value changes.

Cearn's (1999) suggests that the idea of distinguishing between uses and value changes of an asset relates only to the fixed assets of the entity, as opposed to the assets with no depreciation charged, for example investment properties (para 3.6). As far as those assets with no depreciation charged are concerned, the holding or non-holding distinction does

not apply, and all the gains or losses derived from these assets should be reported in the operating component.

Therefore, the idea behind Cearn's (1999) proposed distinction between holding and non-holding items is twofold: first, uses of an asset should be distinguished from the asset's value changes; second, the distinction between uses and value changes of an asset relates only to the fixed assets of the entity.

The twofold holding and non-holding distinctions seem to be inconsistent with the CBVI. Under the CBVI, there is no conceptual distinction between uses and value changes of assets. This is because the CBVI suggests that income is derived from ventures undertaken by the entity. As the source of income, venture incorporates all events that are consequences of or part of the undertaking. Uses of the assets of the entity are just the same as any other activities conducted or occurring during the venture undertaking which give rise to income. Therefore, gains or losses derived from uses of the assets are treated in the same way as the value changes under the CBVI. This is inconsistent with the apparent attempt by Cearn (1999) to distinguish between uses of assets and value changes of assets.

Having rejected the CBVI, the CSVI's ideas seem to be more consistent with the holding and non-holding distinction. Under the CSVI, income must be derived from uses of capital. The consumption of service units represents uses of fixed capital, therefore the measurement of this consumption should be included in income. On the other hand, value changes of fixed capital are not derived from the use of capital, and therefore should be excluded from income. The distinction made between the consumption of service units embodied in the fixed capital, and the value changes of the fixed capital, may be used to explain the idea behind the holding and non-holding distinction that uses of an asset should be distinguished from the asset's value change.

Further, the idea that the distinction between uses and value changes of an asset relates to only the fixed assets of the entity seems to relate to the features of circulating capital under the CSVI. Unlike fixed capital, the role of circulating capital is to *receive*, rather than

impart service units, and leave the production process. The concept of service unit consumption, and thus depreciation, is not applicable to circulating capital. This perhaps explains the distinction made by Cearn's (199) between fixed assets and assets with no depreciation charged.

The Internal and External Events Distinction

Cearn's (1999) does not define 'internal' or 'external events'. Instead, she illustrates the meaning of them by giving examples. The example for 'internal events' is 'value added' activities⁴. The examples for 'external events' are price changes, and 'a loss on a net investment in a foreign subsidiary that is caused by changes in foreign exchange rates' in comparison with sales, cost of sales and other trading activities (paras 2.12, 2.9).

The above examples seem to suggest that the purpose of the internal and external event distinction is to distinguish between events that are initiated by management and can be actively monitored, and those events that are coming from outside of the entity which are less able to be influenced by management. In the examples, the fluctuation of foreign exchange rates is less controllable by management in comparison with value added activities such as sales and cost of sales, which are entity initiated actions and thus can be monitored through management.

Based on the above interpretation of the internal-external distinction, the views of the CBVI again seem to be inconsistent. Under the CBVI, the source of income, venture undertakings are associated with risks. Events that are unexpected and outside management's control, such as fire or robberies are considered part the risks of the venture taking. These events are just the same as any other event, such as sales or cost of sales that are necessarily incurred in the venture undertaking which give rise to business venture income.

⁴ The term 'value added activities' is taken by its ordinary meaning, that is, activities that are associated with combining or transforming factors of production into goods and services that are more valuable than those input factors.

The internal-external event distinction seems to be consistent with the CSVI, considering that the use of capital under the CSVI is usually perceived as purposeful manageable activities. As the source of income, the use of capital is distinguished from other activities which are relatively unplanned. It was discussed earlier that under the CSVI, capital, in the form of fixed assets, is purchased with a view to provide certain kinds of services and it is assumed that the capital will provide the intended services for many years. Therefore, the use of capital, as the provision of the intended services and proactive activities is planned and can be distinguished from events that are coming from outside the entity, for example changes in fixed capital's exchange values, which are relatively less controllable.

In summary, it was demonstrated in this section that, under the operating-other split, the features of the operating component outlined by Cearn's (1999) seem to be consistent with the CSVI. The operating activities refer to day-to-day or central activities of the entity and are consistent with the features of the use of capital under the CSVI. The recurring feature also seems to relate to the CSVI. This is because under the CSVI, the use of capital as the source of income is the constant flow of services provided by the fixed capital structure and therefore may produce recurrent results. That the operating items tend to be non-holding gains seems to relate to the idea under the CSVI that uses of capital have to be distinguished from value changes of the capital and this distinction relates only to the fixed capital of the entity. Finally, the internal and external event distinction is consistent with the feature of uses of capital under the CSVI that uses of capital are purposeful manageable activities and can be distinguished from events coming from outside of the entity which are less controllable.

8.3.2.2 The identification of financial items and the distinctions between the operating component and the other component

Moving away from the operating-‘other’ distinction to the three-way distinction, Cearn's (1999) proposes that, for most businesses, financing items should be classified into a separate component in addition to the operating and the ‘other’ component’. That means a three way split of the operating, the financing and the ‘other’ components. However, for financial institutions, Cearn's (1999) proposes that the two-way split applies and the

financing items of the institution should be included as a segment in the operating component (para 2.17).

Cearns (1999) does not explain the features of the financing component, because

The contents of the 'financing or treasury' component...are likely to be determined by the financial instruments project that is underway at an international level (Cearns, 1999, paragraph 2.16).

Instead, she presents a few examples to illustrate the likely contents of the financing component. The examples include interest expenses and possibly gains and losses on derivatives and other financial instruments (para 2.16). These examples suggest that the financing component of the three way split seems to encompass some items that would be regarded as 'operating', and others that would be regarded as 'other' under the two way operating-'other' split. This is because financing costs may be associated either with operating activities or with particular 'other' activities. This may be illustrated by two examples.

Example one

A manufacturer incurs interest costs that are associated with financing on-going costs of an entity, such as purchases of stock and raw material. These interest costs are recurring and can be considered part of the day-to-day operation, or central activities, of the entity that are within management control. Accordingly, based on the features of the operating items outlined by Cearns (1999), these interest costs would be included in the operating component under the operating-'other' split, while Cearns (1999) suggests that they would be included in the financing component in the three-way split.

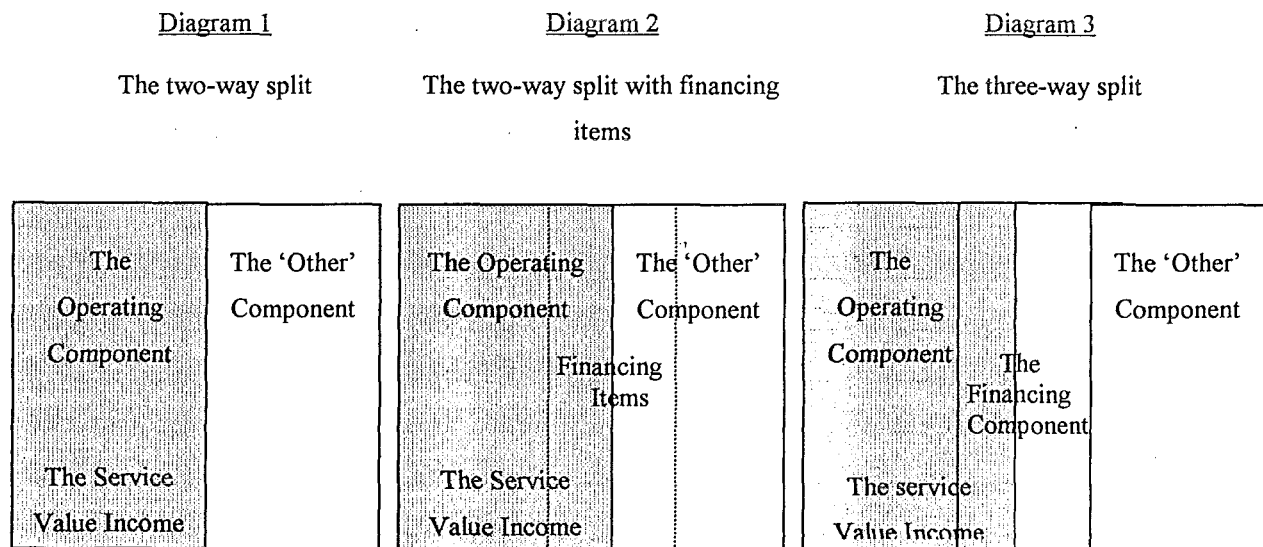
Example two

The same manufacturer borrows to purchase some specialised manufacturing equipment. Interest costs incurred in relation to the purchase of equipment do not seem to relate to the operating activities of the entity, in the sense that purchasing the manufacturing equipment

is not part of the day-to-day operation of the manufacturing business. Therefore, it can be suggested that these interest costs should be excluded from the operating component, but included in the 'other' component under the two-way split, or as Cearns (1999) suggests, in the financing component under the three-way split.

The above examples show that the same entity could derive both financing gains or losses that would be reported in the operating component and the financing gains or losses that would be reported in the 'other' component under the operating-'other' split.

The diagrams below illustrate how the financing items fit with the operating-'other' split. The service value income is incorporated in the diagrams on the basis of the earlier discussion that the operating component seems to report service value income under the operating-'other' split.



In diagram one, the financial statement items are divided into two components: the operating component and the 'other' component, according to the features of the operating items outlined by Cearns (1999) which are recurring, non-holding and being derived from operating activities and internal events. The shaded area represents items of service value income that would be fitted inside the operating component under the operating-other split.

In diagram two, the area within the dotted panel overlaps with the operating component and the 'other'-component. It represents the financing items in the context of the two way split between the operating and the 'other' component. It cuts across the operating-other split which means that the financing activities encompass some items that would be reported in the operating component, and others that would be reported in the 'other' component.

Diagram three illustrates that, under the three-way split of the operating, the financing and the 'other' component, the operating component is narrowed to exclude those financing items that would otherwise be included in the operating component under the two-way split. Those financing items excluded are also service value items and yet they are fitted inside the financing component.

According to the diagrams, the effect of the three way split is that, the financing component prevents the operating component from reporting service value income. This suggests that the identification of financing items, and having them reported separately from other gains and losses, is inconsistent with any desire to report service value income.

Having rejected the CSVI as the conceptual basis for the separation of financing items from other gains or losses, the views of CBVI are now reviewed. Under the CBVI, the venture undertakings, as the source of income, incorporates various kinds of activities. Financing activities are a necessary part of the undertakings and thus give rise to income in the same way as any other venture activities. There is no conceptual distinction between the financing activities and other activities under the CBVI. Accordingly, neither the CSVI nor CBVI help to explain the separation of financing items from other gains or losses.

8.4. Summary

Based on the concepts of income discussed in the previous chapters, this chapter identifies and analyses the income concepts underlying Johnson and Lennard's (1998) and Cearn's (1999) proposals for reporting financial performance.

It was demonstrated that, at the overall level, the single performance statement approach proposed by Johnson and Lennard (1998) seems to be consistent with the CCI interpreted in the context of financial capital maintenance.

At the detailed level, Johnson and Lennard (1998) suggest developing the three way split classification theme for the performance statement. That is, the performance statement should be divided into the operating component, the financing component and the 'other' component. Cearn's (1999) further developed this classification theme, but mainly in respect of the distinctions between the operating and the 'other'-component, claiming that the content of the financing component will be developed later. Cearn's (1999) outlined how operating items should be distinguished from 'other' items by suggesting some features of the operating component. It was demonstrated that these features of the operating component seem to follow the CSVI and thus the operating component seems to report service value income under the operating-'other' split.

Under the three-way split, Cearn's (1999) illustrates the likely content of the financing component by showing some examples, which include interest expenses and possibly gains and losses on derivatives and other financial instruments. Based on the examples, it was demonstrated that the identification of financing items in addition to the operating and the 'other' component does not seem consistent with either the CSVI or the CBVI. The financial component encompasses some items that should be included in the service value income calculation, and thus the operating component is prevented from reporting service value income.

CHAPTER 9

CONCLUSION

9.1 Discussion

The purpose of this research has been to examine the concepts of income underlying Johnson and Lennard's (1998) and Cearn's (1999) proposals for reporting financial performance. Several concepts of income are identified from the literature, the features of which were compared with Johnson and Lennard's (1998) and Cearn's (1999) proposal. They are the concept of service value income, the concept of business venture income, the concept of comprehensive income, and the concept of value added income.

It was demonstrated that both Johnson and Lennard (1998) and Cearn's (1999) seem to have adopted an overall approach to reporting financial performance that is consistent with the concept of comprehensive income. At a more detailed level, Johnson and Lennard (1998) indicate a preference for comprehensive income in the context of financial capital maintenance and suggest developing a classification theme that divides 'financial performance' into three: an operating component, a financing component and an 'other' component (the three way split). Cearn's (1999) develops this classification theme further, but did not discuss the financing component in detail claiming that the content of the financial component would be developed later. Cearn's (1999) discussions are concentrated on the distinctions between the operating component and the 'other' component. It has been demonstrated that the features of the operating component under the operating-'other' split (the two-way split) are consistent with the CSVI.

If, as the G4+1 argues, there is to be a conceptual basis for accounting developments, then arguably there should be a valid conceptual basis for both the single financial statement showing total financial performance, and for the major components of that statement. If it is intended that the operating component reports service value income, while the total

financial performance reports comprehensive income on the basis of financial capital maintenance, then several matters require further consideration.

First, comprehensive income on the basis of financial capital maintenance implies a different asset valuation basis than does the service value income. The two concepts are inconsistent with each other. Second, although the two way split of operating and 'other' components does seem to result in the operating component reporting service value income, the three way split of operating, financing and 'other' components seems likely to prevent the operating component from reporting service value income. Third, the appropriateness and usefulness of service value income in the modern context is questionable and standard-setters do seem to have some awareness of this. Finally, especially in the modern context, the idea that the operating component will help to provide information useful for making predictions appears relatively weak. Each of these above points will be discussed more in depth below.

9.1.1 The Inconsistency between the CSVI and Financial Capital Maintenance

Under the CCI, financial capital maintenance is associated with an approach to determining income which implies valuing all assets at their exchange values. The CSVI however, views fixed assets as a combination of utilities and would value fixed assets on the basis of use value.

With respect to those assets that represent circulating capital of the entity, the CSVI views them as something to be exchanged in the market. Assets of this type are held, modified, produced and valued for their exchange values. Therefore, as far as circulating capital is concerned, it would not be inconsistent with the CSVI, if the assets were measured by their exchange values in determining the comprehensive income in which the service value income is encompassed.

With respect to those assets that represent fixed capital of the entity, the CSVI views them as embodied with service units waiting to be consumed. Fixed assets are retained and

valued for their utility values, not for their exchange values. It would be inconsistent with the CSVI, if these assets were measured by their exchange values rather than their use values in determining the comprehensive income in which the service value income is encompassed. Accordingly, the financial capital maintenance concept, which is the approach that suggests measuring the assets by their exchange values, is inconsistent with the CSVI as far as the fixed capital of entity is concerned.

The inconsistency between the CSVI and the financial capital maintenance has significant impact, because to the extent that fixed assets are a significant component of an entity's operations, the differences between having the fixed assets valued by their exchange value, and having them valued by their use value, may be material. This is especially the case if the fixed assets' exchange value is vastly different from their use value. For example, in the case of a specialised equipment for which there may not be a secondary market, the exchange value of the equipment may be close to nil, but the use value may be very high considering the equipment is specially designed for use in production.

9.1.2 The Three Way Split Will Prevent The Operating Component from Reporting Service Value Income

Both Johnson and Lennard (1998) and Cearn's (1999) agree that 'financial performance' should be classified into three components: the operating component, the financing component, and the 'other' component (the three-way split). However, as the financing component is yet to be developed, Cearn's (1999) discussed mainly the distinctions between the operating component and the 'other' component (the two way split of the operating and the 'other' components).

Under the operating-'other' split, the features of the operating component seem to relate to the CSVI so that the service value income of the entity seems to be represented by the operating component. However, under the three way split, the financing component encompasses some items that would be recognised as service value income. The effect is that the financing component under the three-way split, prevents the operating component from reporting the service value income of the entity. If the intention is that the operating

component report service value income, having a separate financing component seems to defeat that intention.

The apparent attempt to develop a financing component seems to relate to the recent developments in financing activities. When the CSVI was developed, financing activities were relatively simple and consisted mainly of interest costs on borrowings which could be relatively easily classified as either operating or 'other'. In recent decades, the various financial products and instruments developed have undoubtedly promoted financing activities conducted by businesses these days. The result seems to be that both the financing activities and the traditional income producing activities, which usually involve physical asset consumption can provide substantial constant cash flow to the entity. In this way, the traditional distinction between operating activities and an entity's non-operating activities is softened.

As the CSVI was developed in the context of simple financing activities, the above suggests that recent developments of financing activities have reached a level that is beyond the horizon of the CSVI. When the ideas of the CSVI are applied to classify financing items into the operating component, there will be difficulties. The difficulties perhaps explain the apparent attempt to deal with financing items separately from the operating and the 'other' components. This is an indication of the inappropriateness of CSVI in the modern context.

Despite the apparent difficulties, to the extent that the components of the performance statement are to be developed on a conceptual basis, and the operating component is intended to report service value income, the three-way split is flawed because the financing component prevents the operating component from reporting service value income. This flaw is significant and implies the need to rectify the proposed three way split if it is desired that the operating component would report service value income.

9.1.3 The Appropriateness and Usefulness of CSVI in the Modern Context

The CSVI developed in an agricultural economy where income was viewed as being derived from usage of physical assets such as land, or properties. As the source of income, the use of capital is a physical conception in the sense that the capital is physically operated or consumed in the income production process under the CSVI. It is essential to distinguish uses of capital from other activities because income must be the result of the uses of capital. Nowadays, in some cases, such as financial institutions, the CSVI's idea of uses of capital seems to be no longer applicable.

The inapplicability of the CSVI's idea of use of capital perhaps explains the recent development of accounting standards for financial institutions. In a financial institution, most of the assets that are used to produce income do not exist in a physical form, but in a financial form. That is, they represent collections of funds which are to be transferred or invested, rather than physical assets that are designed to be physically consumed. Further, the fixed and circulating capital distinction does not seem to be applicable to financial institutions. Fixed capital, in the context of the CSVI, is identified by its role in the income production process which is to remain and be consumed in a physical sense. Circulating capital, on the other hand, are those assets that receive utilities and leave the production process. For a financial institution, production of income does not necessarily require assets of the entity to be physically consumed or modified, and those assets used to generate income such as foreign currencies, shares, and government bonds do not seem to impart or receive utilities in any sense.

Accounting standards have been developed especially for financial institutions, for example, Australia's accounting standards for general insurance activities AASB 1023. Accounting standards for financial institutions effectively reject the CSVI for financial institutions including banks, general insurance companies, and life insurance companies, in that the distinction between fixed and circulating capital is removed and assets are to be valued at their exchange values, rather than the use values. Despite this rejection of CSVI for financial institutions, Cearn's (1999) suggests that financial institutions should report

financial performance under the two-way split. This seems somewhat inconsistent with the recent accounting standard developments with respect to financial institutions.

The development of special standards for financial institutions does not necessarily overcome inappropriateness of the CSVI. There are other areas where the CSVI must also seem inappropriate. One example is the area that involves rapid changes in technology. Coming from an agricultural background, the CSVI does not seem to work well in the context of technology based businesses where heavy usage of physical assets may no longer be required for income production. This is especially the case in the knowledge-based economy where income is generated by providing information, technology and skills. Usage of physical assets in the income production process is very limited. For example, internet providers, or website designers, produce income through providing information and modern technologies to the consumers and this involves only limited physical asset consumption. In these cases, uses of physical assets provide very limited assistance in producing income. Instead, it is the human resources embodied with knowledge and skills that seem to be the main source of income.

Another indication of the inappropriateness of CSVI in the modern context is in the area where a large component of the businesses' assets is intangible. For example, in some companies, fishing rights, logging rights, copyrights, the franchise obtained to sell goods and services of a known brand, licenses obtained to practice are an essential part of the business operation and thus the income production process. It was outlined earlier that the CSVI's idea of income production involves assets being consumed physically. For the assets to be physically consumed, it necessarily involves physical wear and tear so that the service units embodied in the assets are imparted to the income production process. This idea is not applicable to intangible assets that can not be used or consumed in a physical sense.

With the emergence of various forms of intangible assets in recent decades, accounting standards are being developed at the international level to deal with reporting intangible assets. To be consistent, the accounting standards on reporting intangible assets should be in line with the standards on financial performance reporting. That means, if the CSVI is

adopted in developing financing performance reporting, the same concept should also be applied to reporting intangible assets. However, given the limited application of CSVI in reporting intangible assets, adopting the CSVI in financial performance reporting is questionable.

To sum up, arguably, the ideas of CSVI have been outdated by the changes in the environment, especially with the emergence of various forms of intangible assets, and in the areas of financing activities and electronic technology. It was discussed earlier, that the recent advancement in developing the various financial products and instruments seems to have reached a level that is beyond the horizon of CSVI. Similarly, in the context of financial institutions, knowledge-based economy, and businesses whose main assets are intangible, the ideas of the CSVI have limited application. They all imply that CSVI is inappropriate in the modern context.

9.1.4 The Idea That the Operating Component Will Help to Provide Information Useful for Making Predictions

Cearns (1999) asserts that a key objective of financial reporting is to provide information that is useful in making predictions of the amount, probability and timing of future cash flows of the entity (para 1.6). She argues that the proposed operating component will help to achieve this objective because the operating items relate to central activities of the entity and tend to be recurrent (para 2.9). However, if the operating component were to be prepared based on the CSVI, the operating component would not necessarily provide information on which predictions could be made, because the amounts produced by the CSVI are not necessarily recurrent.

There is a perception that the amounts produced by the CSVI are recurrent so that predictions could be made based on the recurrent items. However, the recurrent nature of the service value income is based on an assumption that assets are purchased with a view to provide certain kinds of services and that the profit-yielding structure of the business is fixed and will always operate for providing the same kind of services. This assumption was made when the CSVI was developed in a relatively static environment on the basis

that there were no rapid changes in market conditions and technologies. Based on that assumption, the source of income, the use of capital, in the form of fixed assets, is considered to provide a constant flow of services from a fixed profit-yielding structure and thus may produce results that are perceived as recurrent.

In today's ever changing business environment, however, the CSVI's assumption that an entity's assets can be used in the same way over many years may not be valid. This is because in a changing environment the need for businesses to be able to adapt to different settings is ever increasing. That means, the assets of the business must be able to provide different kinds of services as the environment requires and that the CSVI's assumption is no longer valid. Because the recurrent feature of CSVI relies on the assumption of the business being static, and to the extent that such an assumption is invalid in a changing business environment, the amounts produced by the CSVI are not necessarily recurrent and may not help with the predictability of the financial information or cash flow.

9.2 Possible Resolutions

Having discussed the limited applications of CSVI in the modern context, it seems that adopting the CSVI in financial reporting is questionable. However, to the extent that the operating component of the proposed financial performance statement is intended to report service value income, the inconsistency between CSVI and financial capital maintenance and the inconsistency between the two-way split and the three-way split are the two issues that require consideration. This of course requires disregarding the inappropriateness of the CSVI in terms of its limited application in the modern context, and its questionable ability to provide useful information for making predictions.

9.2.1 A Possible Resolution of the Inconsistency Between the CSVI and 'Financial Capital Maintenance'

It was discussed previously that Johnson and Lennard (1998) proposes to interpret 'financial performance' in terms of comprehensive income in the context of financial capital maintenance, which suggests measuring assets by their exchange value. This is

inconsistent with the views of the CSVI which suggests valuing fixed assets on the basis of use value. This inconsistency of valuation concepts tends to be overlooked if the assets are not revalued at all and held at historical cost. To the extent that the assets are revalued, however, if the operating component is to be consistent with service value income and yet kept within a statement of financial performance based on financial capital maintenance, then valuation of assets on both bases, the use value and the exchange value would be necessary.

The main issue is how to present changes in asset value and depreciation in the performance statement. At the overall level, the approach requires measuring the comprehensive income in the context of financial capital maintenance. The CCI is a measuring concept, effectively measuring the changes in net assets to determine income. The financial capital maintenance approach, in the context of proprietary theory, to determine comprehensive income means that the assets would be revalued to their current exchange values, and subsequently the revalued amounts would be reported in the balance sheet. The changes in the exchange values would need to be recognised in the performance statement.

Assuming an upward revaluation, to report the revaluation based on exchange values, at the end of every accounting period the exchange value change can be debited to the asset account, and credited to a revaluation account as a gain or loss in the performance statement. As any value change would be rejected by the CSVI as an income item, the exchange value change should be reported in the performance statement as an 'other' gain, instead of an 'operating' gain.

Moving away from the measurement of the comprehensive income to the measurement of the service value income at the detailed level, the use value of fixed assets is important in order to measure the consumption or the using up of those assets during the accounting period. Because CSVI is only a component of CCI, it is not necessary to revalue the fixed assets to their current use value for financial reporting purposes. Rather, the measurement of current use value is necessary only to the extent that the depreciation cost is measured on the basis of the use value.

To report the depreciation costs based on the current use values, the depreciation cost can be debited to the depreciation account to be reported in the performance statement, and credited to the asset account. As depreciation is an item of service value income, the performance statement would show the depreciation in the operating component.

Effectively, the above proposed method can be summarised in the following table (table 5)

Table 5 – The Proposed Method Summarised

Account Required	Location of Account	Basic Journal Entries for Depreciation based on current use value	Basic Journal entries for Revaluation to Current Exchange Value
Asset Account	Balance Sheet	Cr Asset Account	Dr Asset Account
Revaluation Account	Statement of Financial Performance—‘other’ component		Cr Revaluation Account
Depreciation Account	Statement of Financial Performance—operating component	Dr Depreciation	

In the table above, the amount in the revaluation account would consist of the movement in exchange value for the year plus the depreciation charged to the operating component on the basis of the CSVI. The final result in the asset account, after adjusting for depreciation and revaluation, is the assets’ current exchange value. It would be necessary to keep a record of use value in order to determine the amount of depreciation to be charged. Further, if the suggested approach were to be adopted, disclosure of the two valuations may be desirable to achieve disclosure of the two calculations.

9.2.2 A Possible Resolution of for the Inconsistency Between the Two-way and the Three-way Split

It was demonstrated that under the three-way split of comprehensive income, the financing component encompasses some items of service value income so that it prevents the operating component from reporting service value income. If the intention were to

continue with the service value income, then financing items that relate to this concept should be fitted into the operating component. This, in turn requires splitting the financing component into items that should be included in service value income and other financing items. It was demonstrated that the features of the operating component suggested by Cearns (1999) for the operating-‘other’ split, recurring, and non-holding, being derived from operating activities and internal events, are consistent with the CSVI. These same features could be used to make the split between the financing items recognisable as service value income (the operating-financing items), and the rest of the financing items (the non-operating-financing items).

It was noted earlier that the CSVI’s ability to cope with financing activities in today’s environment seems limited. Accordingly, it is accepted that the distinctions between the operating and non-operating financing items are not always easy to draw. However, to the extent that the financing items are required to be dealt with in the present context, there seems to be a need for a component within the performance statement which encompasses those borderline items that cannot be clearly identified as operating items. In this way, the operating component contains those items that are clearly ‘operating’ or ‘service value income’, and those that are clearly non-operating are reported in the ‘other’ component. The borderline financing items that cannot be distinguished are reported separately from the ‘operating’ and ‘other’ component.

It should be noted that, adopting an intermediate component in the performance statement, which encompasses the borderline financing items, does not necessarily mean that the operating component would report service value income. This is because the borderline items are separately reported from the operating component, and it is not clear whether the borderline items should be included in the calculation of service value income. Despite this, by adopting an intermediate component for the border-line items, the intended objective is to have the operating component incorporating *as far as possible* the items that should clearly be included in service value income. That means the operating component would represent a closer approximation of the service value income than that proposed by the three-way split, if not the exact amount.

9.3 *Suggestions for Future Research*

It was discussed previously that the CSVI seems to have limited application in the modern context. In particular, it seems that the development in financing activities has advanced to a level that is beyond the horizon of the CSVI. To the extent that the operating component of the financial statement is intended to report service value income, there seems to be a need to study the nature of financing items in the context of CSVI, or to study how the CSVI could be adapted to deal with financing items.

Further, both Johnson and Lennard (1998) and Cearn's (1999) agree that components of financial performance should assist the users to predict the entity's future cash flows. It was illustrated earlier that the CSVI does not necessarily help to achieve this, because in a changing business environment, businesses have to adapt to different settings as the environment requires, the financial results produced by applying the CSVI are not necessarily recurrent.

Having rejected the CSVI for the discussed reasons, there seems to be a need to investigate the applicability of other income concepts in developing the components of financial performance; and whether these other income concepts may help to achieve the role of financial performance reporting in predicting the entity's future cash flow. One of the alternatives is the CBVI (the Concept of Business Venture Income).

If there were an intention to develop the single performance statement on a conceptual basis, and if the total financial performance is intended to report comprehensive income in the context of financial capital maintenance, the CBVI seems to be a potential alternative that requires special attention for further study. There are at least two reasons to further study the CBVI for the development of the major components of the performance statement.

First, it was demonstrated in this research that, under the CBVI, the measurement of income is from the perspective of the venturers and that assets of the entity are measured at exchange values. Therefore, to the extent that asset valuation is concerned, the CBVI is

consistent with the view of the financial capital maintenance approach for determining comprehensive income.

Second, the main difference between the CBVI and the CCI seems to be that the CBVI distinguishes between realised and unrealised gains or losses whereas the concept of comprehensive income does not make such distinction. Therefore if the CBVI is to be adopted for developing major components of the performance statement which reports financial performance on the basis of CCI, one of the requirements would be to distinguish realised gains or losses from unrealised ones. According to Johnson and Lennard (1998), a classification theme that distinguishes between realised and unrealised gains or losses has been suggested as a possible alternative for reporting the financial performance items. Therefore it seems feasible to develop the major components of financial performance according to the realisation theme and this would seem to follow the idea under the CBVI that realised gains or losses should be distinguished from unrealised ones.

The reason for the CSVI's distinction between realised and unrealised gains and losses may be an important factor. The 'realised' component shows the gains or losses derived by the entity that are in cash form or near cash form. The 'unrealised' component shows the gains or losses that could provide cash to the entity if certain action is undertaken in the immediate future, for example, selling the investment from which the unrealised gains or losses are derived. The unrealised component, in this case, seems to indicate to the users about the entity's capacity, or potential, in generating cash inflows in the short run. This is consistent with the assumed role of financial performance reporting, which is to assist the users to predict the entity's future performance in terms of generating cash inflows.

9.4 Research Limitations

Having discussed the conclusions in this chapter, it should be noted that this research is subject to several limitations.

This research has identified the main concepts of income in the literature of countries in the G4+1 group. The concepts of income identified are not exhaustive due to time and

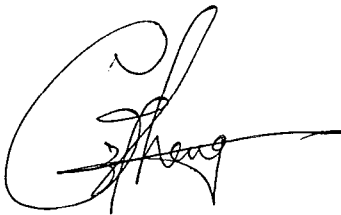
budget constraints. Further this research discusses the income concepts in the context of the related concepts such as valuation concepts, capital concepts, and theories of entity. The discussions of this research on these related concepts are limited to the scope designed to meet the objectives of this research.

In comparing the features of the income concepts identified with Johnson and Lennard's (1998) and Cearn's (1999) proposals for financial performance reporting, the analysis is limited to the discussions available in the two reports. Further, there are technical terms used in Johnson and Lennard (1998) and Cearn's (1999), such as 'fixed assets' 'investment properties', 'value added', for which no definitions have been provided. For the purpose of this research, they have been taken by the meaning used in accounting practice.

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A handwritten signature in black ink, appearing to read 'Geng Zheng', with a large, stylized initial 'G' and a long horizontal stroke extending to the right.

Geng Zheng
Christchurch
January 2001

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